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Research

Business Transfer

Why, How and When?

August 2023

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concierge@nishithdesai.com

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Contact

For any help or assistance please email us on **concierge@nishithdesai.com**
or visit us at **www.nishithdesai.com**.

Acknowledgements

Harshita Srivastava
harshita.srivastava@nishithdesai.com

Ipsita Agarwalla
ipsita.agarwalla@nishithdesai.com

Khyati Dalal
khyati.dalal@nishithdesai.com

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Introduction

In the context of M&A transactions, *how you acquire is as important as what you acquire.* The structure of a transaction could either make or break the deal, especially in a jurisdiction like India where the consequences of a wrong choice of structure could outweigh the benefits of the transaction itself. Therefore, naturally one of the most fundamental considerations in any M&A transaction is the mode of acquisition.

The choice of the mode of acquisition can have far reaching implications for the buyer and the seller, *inter-alia*, in terms of, legal compliances, taxation, successor liability, employee transfer, stamp duty, time and effort for implementation beside the obvious commercial considerations involved. Hence, zeroing in on a structure that works best for the seller and the buyer would be the first step in the deal making process.

Traditionally, the choice for the acquirer has been between, acquisition of the company conducting the business and the acquisition of the business itself. While the former will be through the fairly straightforward acquisition of shares, the latter can be achieved in more ways than one; each with its own set of pros, cons and complexities. In the Indian context, acquisition of a 'business' can be through, transfer of an entire undertaking as a going concern or transfer of just the cherry-picked assets that are required for the business. The transfer of an undertaking itself can be achieved in two different ways: one, a 'slump-sale' and the other, a court approved demerger. Since, each of these modes of acquisitions will have significant and different implications for the buyer and the seller, it is important to choose a structure that meets the expectations of the parties, complies with applicable legal requirements and most importantly, is tax efficient.

Further, in light of the amendment by the Government of India to curb opportunistic takeovers/acquisitions of Indian companies, Press Note No. 3 (2020 Series) dated April 17, 2020 (**"PN3"**) was introduced to restrict foreign direct investment from a country sharing land borders with India. Subsequently, the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019 were also suitably amended to give effect to PN3 on April 22, 2020. In light of these amendments, certain share acquisition transactions might be a challenge to implement.

It is generally perceived that acquirers tend to prefer asset purchase over any other mode of M&A. Obviously, who would not want to cherry-pick only the desired assets and steer clear of historic liabilities of the target. However, asset transfer is not a seller's favourite owing primarily to the tax disadvantage for the seller. As a midway, parties are now increasingly considering 'business transfer' or 'slump sale' as modes for acquisitions. In recent times, we have witnessed a surge in the number of business transfer transactions and there are multiple reasons for its growing popularity.

This paper examines, the basic structure of a 'business transfer', how it differs from other modes of asset sale and the merits and demerits over other modes of acquisition. In doing so, we explain the legal, tax and regulatory implications of a 'business transfer' and also cover certain key commercial considerations that are often heavily negotiated. We also deal with the nuances of 'share transfer' and cover certain regulatory and tax issues as well as challenges that may arise on a 'share transfer'.

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Constituents of a Business Transfer

The terms, 'business transfer' and 'slump sale' are used interchangeably in the Indian context and both refer to transfer and sale of an entire business undertaking of the seller on a going concern basis for a lump-sum consideration. In India, *'Slump sale'* is purely a tax concept and the Income-tax Act, 1961 (**"ITA"**) defines a slump sale under Section 2 (42C) as follows:

> *"Transfer of one or more undertakings, by any means, for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales."*

One of the biggest advantages of slump sale over an asset sale is its tax treatment for the seller. Since, individual values are assigned to each of the assets in an asset transfer, capital gains arising from the sale of assets will also be ascertained for each asset separately. Therefore, depending upon the holding period for each asset there could be short term or long term capital gains on each asset.

In case of a business transfer that meets all the requirements prescribed under ITA, any undertaking that has been held by the seller for more than 36 months shall be deemed to be a long-term capital asset irrespective of how long the individual assets in the undertaking have been held by the seller. Accordingly, the entire profits or gains arising from the business transfer shall be subject to long-term capital gains tax at the rate of 20%[1] if the undertaking has been held by the seller for more than 36 months.[2]

Only if the undertaking has been held for not more than 36 months by the seller will the profits or gains arising from the business transfer be subject to short-term capital gains at rate of 30% in case of domestic companies and 40% in case of foreign companies.

In light of the definition under Section 2(42C) of the ITA and the judicial interpretation of this definition over the years, the following are the fundamental requirements of a business transfer transaction:

A. Transfer by any Means

ITA recognizes multiple forms of transfer under section 2(47) including 'transfer by way of sale' and 'transfer by way of exchange'. The erstwhile definition of slump sale under ITA makes it clear that transfer by way of sale is what would constitute a slump sale and not transfer by any other mode.[3]

In the past, an interesting point that has been discussed and deliberated was whether payment of monetary consideration is mandatory for a slump sale. While it is settled that transfer without any consideration shall not qualify as a slump sale[4] there was some ambiguity on whether consideration in kind would affect the nature of a slump sale transaction. There have been attempts in the past to structure a slump sale in such a manner that consideration for the transfer was paid in the form of shares or other assets. The question is whether such payment of consideration in kind would qualify as, sale or exchange of assets.

1 All the rates in this paper are exclusive of applicable surcharge and cess.

2 Section 50B of ITA.

3 Avaya Global Connect Ltd. v ACIT (26 SOT 397).

4 ITO v. M/s Zinger Investments (P) Ltd [TS-437-ITAT-2013(Hyd)].

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In the matter of CIT v R.R. Ramakrishna Pillai,[5] the Supreme Court has confirmed that, a transfer of an asset for consideration other than monetary consideration is an exchange and not sale.

The Delhi High Court, in the matter of SREI Infrastructure Finance Ltd v. Income Tax Settlement Commission,[6] has ruled that on transfer of business in exchange of another asset, there is indeed a monetary consideration which is being discharged in the form of shares. The Court further held that it would not be appropriate to construe and regard the word 'slump sale' to mean that it applies to 'sale' in a narrow sense and as an antithesis to the word 'transfer' as used in Section 2(47) of ITA.

A contrary view was taken by the Bombay High Court, in the matter of CIT v. Bharat Bijlee Limited[7]. The Bombay High Court upheld the decision of the Income-tax Appellate Tribunal that the transfer of a business undertaking as a going concern against bonds/ preference shares issued was not a sale, but an exchange. Therefore, section 2(42C) and section 50B of ITA relating to the computation of capital gains were not applicable to such a transfer. The Court tried to distinguish the Delhi HC ruling on the grounds that in case of SREI Infrastructure Finance Ltd, the consideration for transfer was both in the form of cash and shares. Since an element of monetary consideration was involved, it could not be said that there is no sale.

However, the Finance Act, 2021 amended the definition of 'slump sale' under the ITA replacing the words "undertaking as a result of sale" with "undertaking, by any means" in the definition of slump sale. The amendment broadens the scope of slump sale to include transfer (as defined under section 2(47) of the ITA) of one or more undertakings by any means and effectively overturning the decision of Bombay High Court in case of Bharat Bijlee Limited.

B. Transfer of an Undertaking

The subject matter of the transfer is yet another defining characteristic of a slump sale. What has to be transferred is one or more undertakings of the seller. The term, "undertaking" is defined under the ITA as follows:

> " *'Undertaking' shall include any part of an undertaking or a unit or a division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.*"

The parties to the transaction have the liberty to identify and agree upon the undertaking to be transferred and the constituents thereto. However, the undertaking agreed to be transferred has to meet the requirements under the ITA.

The transferred undertaking should represent an identifiable stand-alone business activity and should contain all the assets and liabilities including employees, contracts and licenses that are required for conducting such business. The transferred undertaking should have the inherent ability and potential to run the business, which is being transferred and also, generate revenues independently without having to rely on any external support.

5 1967 66 ITR 725 SC.

6 Writ Petition (Civil) No. 1592/2012.

7 [TS-270-HC-2014(BOM)].

While an asset transfer transaction offers the ability to cherry-pick assets and liabilities as the parties may desire, a slump sale transaction demands transfer of all the assets and liabilities that are necessary for conducting the business without any exception.

Ideally, all the assets and liabilities forming part of the transferred business need to be transferred to the buyer in a slump sale but case laws indicate that exclusion of certain assets and liabilities should be permitted so long as the assets and liabilities transferred as part of the undertaking are sufficient for conducting the business and generating sustainable revenue on its own on a standalone basis. This is important especially in case of assets and liabilities of the seller that are shared by multiple divisions of the seller. It is absolutely fine for the seller to retain such shared assets and liabilities provided the buyer provides substitutes for such retained assets and liabilities thereby ensuring that the undertaking is capable of conducting the transferred business on a stand-alone basis.[8]

Apart from the considerations above, it is essential to examine whether certain type of transfers meet the undertaking test. One such transfer is transfer of investment in stock, mutual funds etc. The Bombay High Court in the matter of Principal Commissioner of Income-tax v. UTV Software Communication Ltd[9] while upholding the Tribunal's order has held that mere change in shareholding pattern will not make a transaction slump sale. Accordingly, transfer of shares should not result into transfer of 'undertaking' making it a slump sale for Section 50B of the ITA. Another issue which arises is whether the provisions of section 50B apply even in case of a transfer of a capital asset which is exempt under section 47 of the ITA.

In this regard, it will be essential to appreciate the construct of the provisions of slump sale and capital gains under the ITA. Section 45 contains the charging provision in relation to capital gains and provides that any profits or gains arising from the transfer of a capital asset is chargeable to income-tax under the head 'Capital Gains'. However, section 47 provides a list of transactions which are disregarded as transfer for the purposes of section 45 subject to fulfilment of certain conditions specified therein. Section 50B merely provides for a mechanism for computation of capital gains in case of a slump sale. Therefore, provisions of section 50B cannot override section 45. Accordingly, provisions of section 50B should not be applicable in case of transfer of capital asset which is exempt under section 47. The Chennai Tribunal in the matter of Assistant Commissioner of Income-tax v. Madan Mohan Chandak[10] while dealing with succession of a sole proprietary concern by a company has held that when there is a specific provision i.e. 47(xiv) in the ITA dealing with a particular case, it is not advisable to shift to other similarly worded provision.

C. Transfer as a Going Concern

The single most important requirement of a slump sale is that the undertaking is transferred as a 'going concern'. There should be no break or cessation in the operations of the transferred undertaking. The transfer of the undertaking from the seller and the vesting of the undertaking in the buyer together with all the assets and liabilities should be simultaneous and it should not stop, hinder or break the conduct of the business. Hence, it is important for the buyer to ensure that the buyer has all the requisite infrastructure, licenses and preparedness to start running the business simultaneously with the consummation of the slump sale.

8 Premier Automobiles Ltd. v. ITO (2003) 264 ITR 193 (Bom), as approved CIT v. Max India Ltd. [2009] 319 ITR 68 (P&H).

9 IT Appeal No. 1475 of 2016.

10 IT APPEAL NO. 1256 (MAD.) OF 2009.

D. Lump-Sum Consideration

The consideration for the slump sale has to be a lump-sum figure without attributing individual values to the assets and liabilities forming part of the transferred undertaking. It is not individual assets that the buyer is buying but a stand-alone business in entirety. Therefore, the business has to be valued as a whole and an aggregate consideration for the business has to be arrived at. However, it is clarified that the determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities.

Practically, working capital adjustment may also be required to be undertaken to account for the intervening period between the date of execution of business transfer agreement ("**BTA**") and the actual date of transfer. The nature of transaction should not change from slump sale merely because a working capital adjustment is envisaged under the BTA. This issue is squarely covered by the Bombay High Court in case of Premier Automobiles Ltd vs. ITO[11] (amongst various other issues) wherein it was held that reference to value of net current asset in the slump sale agreement cannot lead one to the conclusion that there was a sale of itemized assets. Further, in case consideration is to be paid in form of deferred payments / earn out, a question may arise as to whether deferred payments should still be construed as 'lump sum' consideration to qualify as slump sale.

In this context, while the dictionary meaning of 'lump sum' regards it as a single payment made at a particular time, it can be argued that since the object of a slump sale is to agree for a consideration without attributing individual values to assets and liabilities, even if such consideration is paid in installments, the 'lump sum' criteria should nevertheless be met.

11 264 ITR 193 (Bom).

Legal, Regulatory & Tax Implications

A. Parties to the Transaction

Business transfer entails hive-off of one or more business undertakings from the seller and vesting of such hived-off undertakings in the buyer. Naturally, for a hive-off and vesting of an undertaking as a going concern to be possible, the buyer and the seller involved will necessarily have to be juristic persons.

Under the Indian exchange control regulations, a non-resident entity is not permitted to conduct business operations in India without having a place of business in India. While a non-resident is permitted to open a liaison office or a branch office in India for limited short-term purposes and subject to the conditionalities set out under the exchange control regulations, full-fledged business operations can only be undertaken through an Indian entity like a company, limited liability partnerships etc. On account of this restriction under the exchange control regulations, it would not be possible for a non-resident to directly acquire an Indian business undertaking. Therefore, for a non-resident to consummate a slump sale or an itemized sale, it has to first establish an Indian entity and then use such Indian entity for acquisition. Typically, the non-resident incorporates a company or a limited liability partnership for undertaking the business transfer if the acquirer does not already have any presence in India.

B. Corporate Authorisations

The charter documents of the seller and the purchaser should have enabling provisions for sale and purchase of a business divisions, respectively. This should not be much of a concern as it is quite standard to cover these provisions in the charter documents of Indian companies. Further, the memorandum of association of the buyer should clearly mention in its main objects' clause, an object covering the business acquired pursuant to the slump sale. If not, the memorandum of association of the buyer will need to be amended tocover in the main objects' clause, the nature of the business of the business undertaking being acquired.

Business transfer transaction would require approval of the boards of directors of the buyer and the seller. Additionally, Section 180 of the Companies Act, 2013 requires an Indian public company selling whole or substantially the whole of its undertaking(s) to procure the prior consent of the shareholders by way of a special resolution[1] before giving effect to such sale. For the purposes of Section 180 of the Companies Act, 2013, (i) 'undertaking' shall mean an undertaking in which the investment of the company exceeds 20% of its net worth as per the audited balance sheet of the preceding financial year or an undertaking which generates 20% of the total income of the company during the previous financial year; (ii) the expression "substantially the whole of the undertaking" in any financial year shall mean 20% or more of the value of the undertaking as per the audited balance sheet of the preceding financial year.

If the undertaking transferred under the business transfer meets the aforesaid conditions, prior consent of the shareholders of the seller (if it is a public company) by way of a special resolution would also be required.

1 Special resolution requires approval of shareholders holding at least 75% of the shares in value, present and voting in a shareholders meeting.

In case the buyer or the seller are listed entities then applicable compliances including disclosures under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“**LODR**”) would also be required. In line with its intent to strengthen corporate governance in respect of listed companies, on June 14, 2023, the Securities and Exchange Board of India (“**SEBI**”) passed significant amendments to the LODR vide the SEBI (Listing Obligations and Disclosure Requirements) (Second Amendment) Regulations, 2023 (“**Amendment Regulations 2023**”). Regulation 30A requires shareholders, promoters, promoter group entities, related parties, directors, key managerial personnel and employees of a listed company or of its holding, subsidiary and associate company to disclose any agreements (to which they are a party) that fall under the scope of Clause 5A of Para A of Part A to Schedule III of the LODR (“**Clause 5A**”) to the listed company (in case the listed company is not a party) within two working days from the date on which they have entered into such agreement. According to Clause 5A, any agreements which indirectly, directly, or potentially, or have the purpose or effect of: (i) impacting the management; or (ii) impacting control of the listed company, or (iii) imposes any restriction or creates liability(ies) upon the listed company, and are not in the ordinary course of business of the listed company, are required to be disclosed by the listed company under Regulation 30A. The Amendment Regulations 2023 have been summarized in further detail in our article.[2]

C. Anti-Trust Clearance

If the business transfer qualifies as a ‘combination’ as defined under the Competition Act, 2002 (“**Competition Act**”) then such combination would require prior consent of Competition Commission of India (“**CCI**”) and would be regulated by the Competition Act and the Competition Commission of India (Procedure in regard to the transaction of business relating to combinations) Regulations, 2011 (“**Combination Regulations**”). CCI would examine if the combination causes or is likely to cause an appreciable adverse effect on competition (“**AAEC**”) in India and would decide on the matter accordingly.

I. Combination

A ‘combination’, for the purposes of the Competition Act means:

- an acquisition of control, shares or voting rights or assets by a person;
- an acquisition of control of an enterprise where the acquirer already has direct or indirect control of another engaged in similar or identical business; or
- a merger or amalgamation between or among enterprises.

That exceed the ‘financial thresholds’ prescribed under the Competition Act.

2 https://www.natlawreview.com/article/sebi-s-amendments-to-lodr-increasing-corporate-responsibility-and-governance-india.

II. Financial Thresholds

Competition Act prescribes financial thresholds linked with assets / turnover for the purposes of determining whether a transaction is a 'combination'. The thresholds are based on the value of assets and turnover of the parties to the combination, i.e., enterprise-level threshold, and the group to which the target would belong after the M&A, i.e., group-level threshold. The threshold also takes into account the geographical limits as to the operation of the business. CCI approval is required only for such combinations that exceed the prescribed thresholds.

The financial thresholds relevant for a business transfer transaction are as follows:

Test 1	Test 2
Parties to the business transfer, i.e. the buyer and the seller, jointly have: ▪ In India, (i) assets higher than INR 2000 crore; or (ii) turnover higher than INR 6000 crore; or ▪ In India or outside, (i) assets higher than USD 1000 million of which assets in India should be higher than INR 1000 crore; or (ii) total turnover in India or outside is higher than USD 3000 million of which turnover in India should be higher than INR 3000 crore.	The acquirer group to which the acquired business would belong after the acquisition [3] have or would have: ▪ In India, (i) assets higher than INR 8000 crore; or (ii) turnover higher than INR 24000 crore; or ▪ In India or outside, (i) assets higher than USD 4 billion of which assets in India are higher than INR 1000 crore; or (ii) turnover higher than USD 12 billion of which turnover in India should be higher than INR 3000 crore.

If any of the aforesaid financial thresholds are met, the business transfer transaction would qualify as a 'combination' under the Competition Act that requires prior consent of the CCI for consummation.

Additionally, the Competition (Amendment) Act, 2023 ("**CCI Amendment**") has recently been introduced which has brought in significant changes to the merger control regime, provisions on behavioral issues as well as the enforcement framework under the Competition Act. The CCI Amendment shall come into force on the date notified by the Central Government in the Official Gazette. As per the changes made to Section 5 on 'Combinations' under the Competition Act, the CCI Amendment has proposed a new deal value threshold which states that any transaction in connection with acquisition of any control, shares, voting rights or assets of an enterprise, merger or amalgamation, the deal value of which exceeds INR 2,000 crore and if such enterprise (i.e. the one being acquired / merged / amalgamated) has 'substantial business operations in India', will require an approval from the CCI. The CCI shall in due course issue regulations to determine the modalities to determine what will constitute 'substantial business operations in India'. For the purpose of this clause, value of the transaction shall include every valuable consideration (whether direct or indirect) including any deferred consideration. The detailed regulations pursuant to the CCI Amendment are awaited.

3 A 'group' for the above purposes would mean two or more enterprises which, directly or indirectly, are in position to –

i) Exercise twenty six per cent or more of the voting rights in the other enterprise; or

ii) Appoint more than fifty per cent of the members of the board of directors in the other enterprise, or

iii) Control the management or affairs of the other enterprise.

III. Exceptions to Filing

To facilitate M&A for small companies, the MCA vide a gazette notification dated March 27, 2017, had extended an exemption from CCI approval to Indian target companies which have assets of not more than INR 350 crore or turnover of not more than INR 1000 crores respectively (“**SME Exemption**”) in India. The SME Exemption also exempts acquisitions where the value of assets acquired is not more than INR 350 crore. As per the SME Exemption, where a portion of an enterprise or division or business is being acquired, taken control of, merged or amalgamated with another enterprise, the value of assets of the said portion or division or business and or attributable to it, shall be the relevant assets and turnover to be taken into account for the purpose of calculating the thresholds under Section 5 of the Act.

However, the SME exemption was only available until March 04, 2021. Now through its notification dated 16 March 2022, the MCA has substituted the period of ‘five years’ in the De Minimis Exemption, with ‘ten years’, thereby extending the exemption benefit for a further period of 5 years, i.e. till 28 March 2027. As per the CCI Amendment, it is also pertinent to note that even if a ‘de-minimis exemption’ is available, a transaction may be notifiable to the CCI if the deal value thresholds are met.

Schedule I to the Combination Regulations specifies certain categories of transactions which are ordinarily not likely to have an AAEC and therefore would not normally require to be notified to the CCI which, *inter alia*, include:

- An acquisition of assets unrelated to the business of the acquirer, or acquired solely as an investment or in the ordinary course of business, not leading to control of the enterprise whose assets are being acquired except when such assets being acquired represent the substantial business operation in a particular location or for a particular product or service of the enterprise, irrespective of whether such assets are organized as a separate legal entity or not; and
- Acquisitions of stock-in-trade, raw materials, stores and spares, trade receivables and other similar current assets (in the ordinary course of business).

IV. Mandatory Reporting

Section 6 of the Competition Act makes void, any combination which causes or is likely to cause an AAEC in India. Accordingly, Section 6 of the Competition Act requires the parties (the acquirer in case of an acquisition) to the combination to notify the CCI and obtain its approval prior to effectuating the transaction.

The CCI must within 30 days of filing, form a *prima facie* opinion on whether a combination has caused or is likely to cause an AAEC within the relevant market in India. The combination can be consummated on the earlier of, expiry of 210 days from the date on which notice is given to the CCI (assuming CCI has not rejected the application), or approval of the transaction by CCI. As per the Competition Amendment, the time period has been reduced to 150 days from the date on which notice is given to the CCI.

V. Pre-Filing Consultation

If the parties to the transaction need clarity on whether a transaction would require prior approval of CCI then the parties may request in writing to the CCI, for an informal and verbal consultation with the officials of the CCI about filing such proposed 'combination' with CCI. Advice provided by the CCI during such pre-filing consultation is not binding on the CCI.

VI. Interconnected Transactions

Sections 5 and 6 of the Competition Act, read with Regulation 9(4) of the Combinations Regulations, prescribe mandatory prior notification as a single transaction of a notifiable multi-step 'interconnected transaction' to the CCI at before the first instance of occurrence of any step leading to the consummation of such an inter connected transaction. Accordingly, where one or more transactions in a series of transactions are exempt from CCI's notification requirements, but are nevertheless interconnected to a notifiable transaction, parties need to: (i) file a composite notice with CCI with details of all transactions, including 'exempt' but interconnected transactions; and (ii) ensure that no transaction is implemented, including the exempt transaction(s), prior to receipt of approval from CCI.

When considering a business transfer as a part of interconnected transactions, it becomes crucial to evaluate the notification requirement to the CCI. Given the potential impact on competition within the relevant markets, a comprehensive analysis of the interconnected nature of the transactions can help determine whether the transfer triggers the threshold for mandatory notification to CCI, ensuring compliance with the competition laws and regulations.

D. Tax Implications of Slump Sale

I. Goods and Services Tax (GST)

As per the notification No. 12/2017-Central Tax (Rate) dated June 28, 2017, services by way of transfer of a going concern, as a whole or part thereof, shall be exempted from the levy of GST. Accordingly, there should be no GST on sale of the business as a slump sale on a going concern basis. Further, this view has also been upheld by Authority for Advance Ruling (Goods and Service Tax) Uttarakhand and Karnataka.[4]

Similarly, there is no GST in case of share transfer as 'securities' are specifically excluded from the definition of 'goods' and 'services' under the GST law.

4 Authority for Advance Ruling, Karnataka in the case of M/s. PICO2FEMTO Semiconductor Services Private Limited (KAR ADRG 12/2023 dt. 20.03.2023 at https://gstcouncil.gov.in/ms-pico2femto-semiconductor-services-private-limited, and Authority for Advance Ruling, Uttarakhand in the case of Innovative Textile Ltd (No.20 dated Mach 26, 2019 at https://gstcouncil.gov.in/innovative-textile-ltd).

II. Direct Tax

a. Income-Tax Implications for Seller

Section 50B of the ITA deems profits and gains arising from a slump sale are chargeable to tax as capital gains. For purposes of computing capital gains from a slump sale, the net worth of the undertaking is deemed to be the cost of acquisition. Prior to the Finance Act, 2021, there was no stipulation regarding the determination of the full value of consideration ("**FVC**") for computing capital gains in case of slump sales. However, the Finance Act 2021 brought about an amendment in this regard which provides that the FVC shall be deemed to be the fair market value ("**FMV**") of the undertaking to be determined as per prescribed rules.

In this regard, the Central Board of Direct Taxes ("**CBDT**") has prescribed valuation rules for determination of FVC for slump sale under Rule 11UAE of the Income-tax Rules, 1962 ("**Valuation Rules**"). The Valuation Rules provide two methods for determining the FVC as on the date of slump sale and the higher of the two shall be considered to be the FVC.

a. **Book value-based formula**: Broadly under this method, the FVC is a function of the book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) as reduced by the book value of all the liabilities;

b. **Actual consideration received**: This should be a sum of the monetary and non-monetary consideration received or accrued as a result of the slump sale. The Valuation Rules also prescribe the method for computing value of the non-monetary consideration received on account of slump sale.

The seller is also required to furnish a report in prescribed form from a chartered accountant indicating that the computation of net-worth of the undertaking being transferred by way of slump sale has been correctly arrived in accordance with provisions of the ITA.

One of the downsides of a slump sale as against an asset sale is the risk of successor liability in case of slump sale as against asset sale, since in case of a slump sale, the assumption is that the undertaking is being transferred together with all attendant assets and liabilities.

Section 170[5] of the ITA provides the rule with respect to income tax liability in case of succession of a business. As a general rule, where a business is succeeded by any other person, who subsequently continues to carry on that business, the predecessor is assessed for the income of financial years prior to the date of succession and the successor is assessed on the income of the financial years after the date of succession. However, as an exception to this general rule, the successor is liable for the income tax in respect of income attributable to the two financial years immediately preceding the date of succession (including any gain accruing to the predecessor from the transfer of the business or profession) in the event that the predecessor cannot be found or where the predecessor has been assessed but the tax cannot be recovered from him.

As per the Finance Act, 2022, a new deeming fiction through sub-section (2A) to Section 170 in the case of a 'business reorganization' was introduced. As a result of the deeming provision, the assessments/proceedings (whether pending or completed) on the predecessor entity made during the course of pendency of the scheme/reorganization application before the relevant court, are deemed to have been made on the successor. There will not be any impact on account of the amendment to share transfer transactions or slump sale transactions.

b. Income-Tax Implications for Buyer

The buyer is not required to withhold tax on payment of consideration for slump sale to the seller. In case of a share transfer, the income-tax implications may be different for the incoming investor i.e. the buyer and the existing shareholder i.e. the seller. We have discussed this in further detail in the next chapter.

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5 Section 170 of the ITA:

1) Where a person carrying on any business or profession (such person hereinafter in this section being referred to as the predecessor) has been succeeded therein by any other person (hereinafter in this section referred to as the successor) who continues to carry on that business or profession,—

   a) the predecessor shall be assessed in respect of the income of the previous year in which the succession took place up to the date of succession;

   b) the successor shall be assessed in respect of the income of the previous year after the date of succession.

2) Notwithstanding anything contained in sub-section (1), when the predecessor cannot be found, the assessment of the income of the previous year in which the succession took place up to the date of succession and of the previous year preceding that year shall be made on the successor in like manner and to the same extent as it would have been made on the predecessor, and all the provisions of this Act shall, so far as may be, apply accordingly.

2A) Notwithstanding anything contained in sub-sections (1) and (2), where there is succession, the assessment or reassessment or any other proceedings, made or initiated on the predecessor during the course of pendency of such succession, shall be deemed to have been made or initiated on the successor and all the provisions of this Act shall, so far as may be, apply accordingly.

   Explanation: For the purposes of this sub-section, the term 'pendency' means the period commencing from the date of filing of application for such succession of business before the High Court or tribunal or the date of admission of an application for corporate insolvency resolution by the Adjudicating Authority as defined in clause (1) of section 5 of the Insolvency and Bankruptcy Code, 2016 (31 of 2016) and ending with the date on which the order of such High Court or tribunal or such Adjudicating Authority, as the case may be, is received by the Principal Commissioner or the Commissioner.

3) When any sum payable under this section in respect of the income of such business or profession for the previous year in which the succession took place up to the date of succession or for the previous year preceding that year, assessed on the predecessor, cannot be recovered from him76a, the 77[Assessing] Officer shall record a finding to that effect and the sum payable by the predecessor shall thereafter be payable by and recoverable from the successor, and the successor shall be entitled to recover from the predecessor any sum so paid.

4) Where any business or profession carried on by a Hindu undivided family is succeeded to, and simultaneously with the succession or after the succession there has been a partition of the joint family property between the members or groups of members, the tax due in respect of the income of the business or profession succeeded to, up to the date of succession, shall be assessed and recovered in the manner provided in section 171, but without prejudice to the provisions of this section.

   Explanation: For the purposes of this section, 'income' includes any gain accruing from the transfer, in any manner whatsoever, of the business or profession as a result of the succession.

Business Transfer vs. Share Transfer

The term 'share transfer' is not defined under the ITA. It essentially covers transfer of investments in shares/ stock of a company to another person. When share transfer is undertaken with an objective to transfer the underlying business of the target company, typically, the existing shareholders of the target company undertake a secondary sale of their shares to the incoming investor at a pre-agreed consideration. While the income-tax implications largely depend upon the manner in which such share transfers are structured, we have captured the broad income-tax implications arising on share transfer in this section below.

The existing shareholder may realize a gain or a loss on such share transfer. The taxation of gains realized on share transfer would depend on whether such shares are held as capital asset or as stock-in-trade. In case shares are held as stock-in-trade, profits and gains from transfer of shares will be chargeable to tax under head 'profits and gains from business and profession'. Where the shares are held as capital asset, profits and gains arising from transfer of capital asset will be chargeable to tax under head 'capital gain' according to section 45 of the ITA. Section 2(14) of the ITA defines the term 'capital asset' to include property of any kind held by an assessee, whether or not connected with his business or profession, but does not include any stock-in-trade or personal assets subject to certain exceptions. Determination of the character of investment, whether it is a capital asset or stock-in-trade has led to a lot of litigation and uncertainty. The CBDT has, vide circulars dated February 29 and May 2, 2016, laid down the following principles in respect of characterization of income arising on sale of securities:

- In respect of income arising from sale of listed shares and securities which are held for more than 12 months, the taxpayer has a one-time option to treat the income as either Business Income or Capital Gains and the option once exercised, is irreversible.
- Gains arising from sale of unlisted shares are characterized as Capital Gains, irrespective of the period of holding of such unlisted shares, except in cases where (i) the transaction is considered to be sham or not genuine, (ii) corporate veil is lifted, or (iii) the transfer is made along with control and management of the underlying business. In such cases, the CBDT has stated that the Indian revenue authorities would take an appropriate view based on the facts of each case.

  The CBDT has clarified that the third exception i.e. where the transfer of unlisted shares is made along with control and management of the underlying business will not be applicable in case of transfer of unlisted shares by SEBI registered Category-I and Category-II Alternative Investment Funds.[1]

A. Implications in Hands of Seller

According to section 48 of the ITA, capital gain is computed by deducting from the consideration received on account of transfer of capital asset:

a. the amount of expenditure incurred wholly and exclusively in connection with such transfer;

b. the cost of acquisition ("**COA**") of the asset and the cost of any improvement thereto.

1 F.No.225/ 12/ 2016/ ITA/ II dated January 24, 2017.

Further, in case of long term capital gains ("**LTCG**"), the COA is adjusted for inflation factors[2] as declared by the CBDT ('**indexation benefit**'). The indexation benefit is not available in certain cases being *inter-alia* LTCG arising to a non-resident on transfer of shares an Indian company. Section 49 of the ITA provides for specific provisions for determination of COA for certain modes of acquisition and section 55 of the ITA provides the meaning of cost of improvement and COA.

B. Capital Gains are Liable to Tax Based on

- The duration for which the corresponding investment has been held prior to sale; and
- The manner in which the sale is effected.

Gains arising on listed shares held for more than 12 months would be classified as LTCG; in any other case, such gains would be classified as short-term capital gains ("**STCG**"). Gains arising on unlisted securities held for more than 24 months would be classified as LTCG; in any other case, such gains would be classified as STCG.

LTCG arising from transfer of listed equity shares in a company on or after April 1, 2018 and where such transactions are liable to Securities Transaction Tax ("**STT**") on acquisition and transfer of such equity shares such LTCG are taxable at the rate of 10%, without taking into account the indexation benefit and benefit of foreign exchange fluctuations, if any to the extent such capital gains exceed INR 0.1 million. The taxpayers have been granted the benefit of set up of COA based on the fair value of the listed equity shares as on January 31, 2018.

CBDT has notified[3] certain transactions of acquisition of equity shares (like initial public offer, offer for sale, merger, shares allotted to qualified institutional buyers, bonus issue etc.) on which the aforesaid condition of payment of STT shall not apply and accordingly, the LTCG on transfer of such equity shares shall be taxable at the rate of 10%, as stated above. Further, taxability of capital gains in other cases (i.e. other than long-term capital gains arising from transfer of listed equity shares) is provided in the table below:

S No.	Particulars	Taxability	
		Resident shareholder	Non-resident shareholder
1	**Sale of long-term capital assets being listed equity share not taking place on floor of a recognized stock exchange**	20% with indexation benefit or 10% without indexation benefit, whichever is more beneficial	10% without indexation benefit
2	**Sale of long-term capital asset being unlisted equity shares**	20% with indexation benefit	10% (no indexation benefit and no benefit with regard to protection from foreign exchange fluctuations)
3	**Sale of a short-term capital asset, being an equity share or unit of an equity-oriented fund on the floor of recognized stock exchange**	15%	15%
4	**Sale of a short-term capital asset being unlisted equity share**	30%	40%

2 The base year for computing the indexation benefit is April 1, 2001. Accordingly, the capital assets that were acquired on or before April 1, 2001, the market value as on April 1, 2001 may be substituted for actual cost while calculating capital gains.

3 Notification No. SO 5054(E) dated October 1, 2018.

In addition to above, in case where the buyer is not required to withhold tax on payment of consideration (exceeding INR 50 lakhs) for acquisition of shares, the seller[4] is required to collect tax at source at rate of 0.1% of the sale consideration in excess of INR 50 lakhs.[5] The tax collected and deposited by the seller is creditable in hands of the buyer.[6]

According to Section 90(2) of the ITA, taxation of non-residents is governed by the provisions of the ITA, or the relevant tax treaty entered between India and the country of residence of the non-resident, whichever is more beneficial to the taxpayer. Further, under section 90(4) of the ITA a tax residency certificate (“**TRC**”) containing the prescribed information issued by the home jurisdiction has been made a de *minimus* requirement for claiming benefits of the tax treaty[7] for a non-resident. The sufficiency of a TRC as evidencing residential status and for claiming benefits of the tax treaty has also been clarified vide Circular[8] issued by the CBDT. Relevant to note that the said circular was issued in the context of TRCs issued by Mauritian tax authorities for accepting the status of residence and beneficial ownership for India-Mauritius tax treaty purposes. Further, a Press Release dated March 1, 2013 released by the Finance Ministry, states that the tax authorities should not go beyond the TRC and question taxpayers on their residential status. Further, Bombay High Court in case of Indostar Capital[9] upheld the validity of TRC of the person claiming the tax treaty benefit and that the principle that TRC should be a sufficient document to claim the benefit is in line with settled principles of law as well as circulars issued by CBDT.

C. Implications in Hands of Buyer

- In the case of acquisition of shares, the entire consideration paid by the buyer becomes the COA of the shares for the buyer, but there is no step-up in the cost basis of the assets of the target company.
- The buyer[10] will be required to withhold tax at rate of 0.1% at the time of payment of consideration for purchase of shares if the seller is an Indian resident.[11,12]
- Where a transfer of shares takes place between two related parties where one of them is a non-resident, transfer pricing guidelines shall apply and accordingly, the transaction shall have to be effected at an arm’s length price.
- According to section 56(2)(x) of the ITA, where any person, receives shares of a company, from any person at a consideration less than the FMV of such shares, the difference between the consideration and the FMV will be taxable under head income from other sources in the hands of transferee.

Additionally, another major implication of share transfer is the ability of the target company to carry forward and set off its business loss (if any). As per section 79 of the ITA, a company in which public is not substantially

4 For the purposes of section 206C(1H), seller means a person whose total sales, gross receipts or turnover from the business carried on by him exceed INR 10 crores during the financial year immediately preceding the financial year in which the sale of goods is carried out.

5 Section 206C(1H) of the ITA.

6 Section 206C(4) of the ITA.

7 In case the particulars prescribed by the Indian Government do not appear in the TRC, the non-resident taxpayer shall, in addition to the TRC, submit a declaration in Form 10F providing such missing details.

8 Circular No 789 dated April 13, 2000.

9 Indostar Capital vs ACIT [(2019) 105 taxmann.com 96 (Bombay)].

10 For the purposes of section 194Q, buyer means a person whose total sales, gross receipts or turnover from the business carried on by him exceed INR 10 crores during the financial year immediately preceding the financial year in which the sale of goods is carried out.

11 Section 194Q.

12 Provisions of section 194Q do not apply to transactions in securities traded on recognized stock exchange.

interested shall not be eligible to carry forward and set off the losses incurred in earlier years, if there is a change of beneficial shareholding carrying 51 per cent or more voting power in such company. However, in case of eligible start-ups as referred to in section 80-IAC, the carry forward and set off provisions would be available where the existing shareholders continue to hold all the shares which they were holding in the year in the which the loss occurred, without satisfying the 51 per cent condition and such loss has been incurred during the period of ten years beginning from the year in which such company is incorporated. Section 79 of the ITA also sets out certain instances wherein the above provision will not be applicable such as, a change in the voting power and shareholding takes place in a previous year consequent upon the death of a shareholder or on account of transfer of shares by way of gift to any relative of the shareholder making such gift.

The table below provides a comparative analysis between slump sale and share sale.

S No.	Parameters	Slump sale	Share sale
1	**Meaning**	Transfer of one or more undertakings by any means for lump-sum consideration on a going concern basis without values being assigned to individual assets and liabilities being transferred.	Acquisition in whole or part of the shareholding of a company from existing shareholders. Unless specifically agreed, the seller has no continuing interest in, or obligation with respect to the assets, liabilities or operations of the business.
2	**Document**	Business transfer agreement	Share purchase agreement
3	**Consideration**	FVC to be determined as per the Valuation Rules	Acquisition of shares to be undertaken at FMV determined as per Rule 11UA of the Income-tax Rules, 1962 (“**ITR**”)
4	**Approval under PN3**	Not applicable	PN3 implications to be evaluated in each share sale
5	**Other approvals**	Regulatory/ contractual approvals for transfer of the business undertaking to be evaluated	Regulatory/ contractual approvals in light of change in control/ shareholding to be evaluated
6	**Capital gains**	Capital gains realized on transfer of the undertaking, if undertaking held for: more than 36 months, are taxed as LTCG. less than 36 months, are taxed as STCG For computing capital gains, COA would be ‘net-worth’ of the undertaking on the date of transfer.	Capital gains realized on transfer of listed shares, if held for more than 12 months is taxed as LTCG, otherwise taxed as STCG Capital gains realized on transfer of unlisted securities, if held for more than 24 months taxed as LTCG; otherwise taxed as STCG
7	**Carry forward of losses**	Not allowed	Permissible if change in shareholding does not exceed 49%
8	**Goods and Services Tax**	GST not applicable	GST not applicable
9	**Stamp Duty**	Rate is state specific	0.015% of the sale consideration
10	**Successor liability**	Purchaser considered as successor of undertaking being brought under slump sale, therefore, risk of successor liability. However, entity level tax liabilities do not get transferred under slump sale	Not applicable

Challenges in a Business Transfer

A. Determining Cost of Acquisition of the 'Undertaking'

Prior to the Finance Act of 1999, there was an ambiguity on how to ascertain the COA of the business being transferred on a going concern basis and relying on the Supreme Court ruling in BC Srinivasa Shetty,[1] where it was held that the charging provisions and the computation mechanism together form an integrated code and that if the COA is unascertainable, then no capital gains tax liability should arise. In the context of a business transfer, a similar view was taken by the Mumbai Tribunal in the case of Bharat Bijlee Ltd. vs. ACIT,[2] wherein it was reiterated that since the COA of a business as a going concern cannot be ascertained, the computation mechanism fails and as such the transaction is not liable to capital gains tax. The same principle was again re-iterated by the Supreme Court in the case of *PNB Finance Ltd. v. CIT.*[3]

It was only in the Finance Act of 1999 that the ITA was amended to provide for the taxability of a slump sale.

Under Section 50B of the ITA, which sets out the rule for taxation of a slump sale, provides that the COA of an undertaking or a division being transferred by virtue of a slump sale shall be its net worth, without indexation. Section 50B also defines 'net worth' to mean the aggregate value of total assets of the undertaking or division as reduced by the value of liabilities of such undertaking or division as appearing in its books of account, without accounting for the change in the value of assets on account of revaluation of assets.

The ITA also provides that the 'aggregate value of total assets of the undertaking or division' for the purposes of computation of the net worth shall be the sum total of:

a. written down value as determined under Section 43(6)(c)(i)(C) of the ITA in case of depreciable assets;

b. nil, in case of assets for which the whole expenditure is allowable as a deduction under section 35AD of the ITA; and

c. book value of the assets, for other assets.

In this regard, a report of a chartered accountant in Form 3CEA certifying that the net worth has been correctly arrived at in accordance with Section 50B of the ITA is required to be submitted by the seller along with its tax returns.

It is important to note here that neither Section 50B of the ITA, nor Form 3CEA lays down the date as on which the net worth is to be determined. However, there have been certain rulings where the courts have held that the net worth determination should be undertaken as on the date of transfer.

Another point of consideration in relation to determination of COA in slump sale cases is the manner of treatment of negative net worth for computation of capital gains on slump sale. Contrary views have been emerged from judicial precedents on this issue. The Mumbai Tribunal in the case of *Zuari Industries Ltd. v. ACIT*[4] and the Delhi Tribunal in the case of *PaperBase Co. Ltd*[5] have held that negative net worth should be ignored, and the cost of undertaking should be considered as 'Nil'. However, the special bench of Mumbai

1 AIR 1981 SC 972.

2 ITA No. 6410/ MUM/ 2008.

3 (2008) 307 ITR 75 (SC).

4 [2007] 105 ITD 569 (Mum ITAT).

5 [2008] 19 SOT 163 (Del ITAT).

Tribunal in case of Summit Securities Ltd[6] has held that negative figure of net worth cannot be ignored for working out capital gains in case of a slump sale under section 50B. An appeal before the High Court is pending on this issue both in the case of Zuari Industries Ltd. and Summit Securities Ltd.

B. Goodwill vs. Non-Compete

In any slump sale transaction, there is always a debate on how the buyer should regard the excess paid over the book value of the assets to the seller. Whether such excess should be characterized by the buyer in the nature of *non-compete fees or goodwill* or should such excess be simply *spread over the assets by recording each of the assets at higher value in its books*. Each option has its own set of legal and tax challenges.

It is important to clarify that while the buyer may attach values to the assets in his own books, from an Indian tax perspective, it should be ensured that in slump sale transactions, a lump sum consideration must be paid by the buyer to the seller without assigning values to individual assets or liabilities. Any assignment of values in the business transfer agreement can lead to the slump sale being qualified as an asset sale; however, assignment of values to individual assets for the computation of stamp duty is expressly permitted under the ITA.

Goodwill or Non-Compete

a. *If treated as goodwill:*

- **Implications on Buyer**
  - Buyer will not be able to claim depreciation on goodwill. In cases where buyer has claimed depreciation on goodwill prior to FY21-22, the buyer is required to pay tax on excess depreciation claimed on goodwill in certain circumstances.
  - Strengthens the non-compete provision from an Indian Contract Act perspective, which largely hinges on the extent of goodwill acquired.
- **Implications on Seller**
  - Seller should largely be indifferent as he will anyway be subject to capital gains tax on the same.

b. *If treated as non-compete fees:*

- **Implications on Buyer**
  - Buyer may be able to claim depreciation or claim it as revenue expense based on the nature of non-com pete.
  - GST at applicable rate, which can be agreed to be borne by a party in a manner decided between the buyer and seller.
- **Implications on Seller**
  - Seller may have to pay income tax under the head profits and gains of business or profession on non-compete fees if the non-compete fee is paid independent of the business transfer under the provisions of Section 28(va) of the ITA.

6 [2012] 145 TTJ 273 (Mumbai) (SB).

I. Taxability of Non-Compete Fee

From a seller's point of view, the treatment of LTCG would be beneficial for the seller and available only if the entire consideration is treated as a capital receipt, provided that the undertaking as a whole is more than three (3) years old (*Please refer to Chapter 1 of this paper*). As against that, from a buyer's point of view, he may want part of the consideration to be allocated to non-compete, which could be characterized as revenue expenditure in certain cases, or depending on the facts, as capital expenditure towards acquisition of an intangible right, eligible for amortization. On account of such conflicting tax objectives, one of the most debated issues in slump sale agreements is whether separate considerations should be attributed to non-compete and to business transfer or should the consideration be clubbed, and no separate allocation should be made for non-compete.

Section 28(va)[7] of the ITA, introduced by the Finance Act, 2002, provides that any consideration received under an agreement, in cash or otherwise for (i) not carrying out any activity in relation to any business; or (ii) not sharing any know-how, patent, copyright, trade-mark, license, franchise or any other business or commercial right of similar nature or information or technique that is likely to assist in the manufacture or processing of goods or provision for services, should be characterized as business income and hence, should be taxed accordingly. However, the section provides an exception for any sum, received, in cash or otherwise, for transfer of the right to manufacture, produce or process any article or thing or right to carry on any business, which should be characterized as capital gains and taxed accordingly. In this regard, Section 55(2)(a)[8] of the ITA provides that the COA of such right shall be the purchase price, where such right was acquired from a previous owner, or else shall be deemed to be nil.

In this regard, it may be noted that the courts have held that only when the non-compete fee is received as a consideration for the transfer of all assets of the business, that is, as a part of business transfer or asset transfer, by virtue of the proviso to Section 28(va) of the ITA, such non-compete fee shall be charged under the head 'capital gains'. However, in any other case, such as, where the non-compete fee is received independent of the business / asset transfer, or where the non-compete fee is received, such amounts shall be characterized as business income and taxed at the higher rate of 30% (40% in case of a foreign company) as against the rate of 20% (provided the business is held for a period exceeding 36 months) for income arising out of income.

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7 Section 28(va) of ITA: Any sum, whether received or receivable, in cash or kind, under an agreement for—

a) not carrying out any activity in relation to any business; or

b) not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services:

Provided that sub-clause (a) shall not apply to—

i) any sum, whether received or receivable, in cash or kind, on account of transfer of the right to manufacture, produce or process any article or thing or right to carry on any business, which is chargeable under the head 'Capital gains';

ii) any sum received as compensation, from the multilateral fund of the Montreal Protocol on Substances that Deplete the Ozone layer under the United Nations Environment Programme, in accordance with the terms of agreement entered into with the Government of India.

8 Section 55 of the ITA: (2) For the purposes of sections 48 and 49, 'cost of acquisition',—

a) in relation to a capital asset, being goodwill of a business or a trade mark or brand name associated with a business or a right to manufacture, produce or process any article or thing or right to carry on any business, tenancy rights, stage carriage permits or loom hours,—

i) in the case of acquisition of such asset by the assessee by purchase from a previous owner, means the amount of the purchase price; and

ii) in any other case [not being a case falling under sub-clauses (i) to (iv) of sub-section (1) of section 49, shall be taken to be nil;

It can be argued that a non-compete is merely in the nature of fees paid, which can well be independent of the acquisition of the undertaking and to that extent, payment of non-compete fees should not impact the nature of the 'slump sale'. However, since non-compete payments post Finance Act, 2012 came under the 'service tax' umbrella, and continues to be within the ambit of GST,[9] the feasibility of such option needs to be weighed carefully.

On the other hand, from a contract law perspective, enforceability of non-compete obligation hinges on the extent of goodwill that the buyer has purchased. Non-compete provisions may not be enforceable if no goodwill has been purchased as per Section 27[10] of Indian Contract Act, 1872. Again, from a buyer's perspective, it is always better to allocate maximum price to goodwill to fortify the non-compete provisions against the seller. As a middle ground, parties may agree not to specify any value to goodwill in the contract and may embed the purchase price of the goodwill in the total purchase consideration for business transfer to strengthen the argument of 'slump sale' without assigning specific values. Buyer may then allocate purchase price on the basis of FMV of the assets purchased and recognize the consideration in excess as goodwill.

II. Depreciation of Goodwill and Non-Compete Fee

a. Goodwill

The Supreme Court in case of SMIFS Securities Limited[11] has held that goodwill falls in the category of 'any other business or commercial rights of similar nature' and should be eligible for depreciation as per the provisions of section 32 of the ITA. The Supreme Court elucidated upon the concept and meaning of the term 'asset' as defined in Explanation 3 of Section 32(1)(ii) of the ITA and held that depreciation on goodwill is contemplated under the ITA and hence, should be allowed. The Supreme Court held:

> *"... the expression 'asset' shall mean an intangible asset, being know-how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature. A reading the words 'any other business or commercial rights of similar nature' in Clause (b) of Explanation 3 indicates that goodwill would fall under the expression 'any other business or commercial right of a similar nature'. The principle of ejusdem generis would strictly apply while interpreting the said expression which finds place in Explanation 3(b)."*

Before the Supreme Court's decision various courts had held the view that Section 32(1) of the ITA specified six categories of intangible assets (know-how, patents, copyrights, trademarks, licenses, franchises) which were entitled for depreciation. Relying on the rule of ejusdem generis, the courts[12] have denied depreciation on goodwill.

9 Schedule II, Paragraph 5(e) of the Central Goods and Services Tax Act, 2017.

10 Section 27 of the Indian Contract Act, 1972: 'Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void. Saving of agreement not to carry on business of which goodwill is sold. Exception 1: One who sells goodwill of a business may agree with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer or any person deriving title to the goodwill from him, carries on a like business therein, provided that such limits appear to the court reasonable, regard being had to the nature of the business.'

11 Civil Appeal No. 5961 of 2012.

12 Borkar Packaging Pvt. Ltd. vs. ACIT ((2010)131TTJ 99 (Panji), Bharatbhai J. Vyas vs. ITO (ITA No. 1260 of 2004.

The Finance Act, 2021, lay the debate on allowability of depreciation on goodwill to rest by simply excluding goodwill from the ambit of depreciable assets. The Memorandum to the Finance Act, 2021 noted that goodwill of a business or a profession has not been specifically provided as an asset either in the definition under section 2(11) (defined the term 'block of assets') or in Section 32 of the ITA. It also noted the decision rendered by the Supreme Court in case of Smiff Securities and other provisions relevant for calculation of depreciation under the ITA.

b. In this Regard, the Memorandum Noted as Under

> *"It is seen that Goodwill, in general, is not a depreciable asset and in fact depending upon how the business runs; goodwill may see appreciation or in the alternative no depreciation to its value. Therefore, there may not be a justification of depreciation on goodwill in the manner there is a need to provide for depreciation in case of other intangible assets or plant & machinery. Hence there appears to be little justification for depreciation on goodwill even in the category of cases referred to in the immediately preceding paragraph."*

These amendments inter-alia provide that (i) goodwill will be excluded from part of Block and list of intangible assets, (ii) adjustments in Block to offset the impact of depreciation claimed in past, (iii) manner of computing cost of goodwill in different scenarios etc. Therefore, any goodwill arising pursuant to a slump sale will not be depreciable for tax purposes. Though the amendment is said applicable prospectively, it will also impact any transactions undertaken in the recent past wherein goodwill was recorded in the books and on which depreciation was claimed for tax purposes (in cases where the entire block of intangible asset comprising of goodwill has not been substantially depreciated).

The CBDT has notified a new rule which provides for the manner in which the opening WDV of the Block of intangible assets comprising of any goodwill is to be recomputed.[13] Apart from the loss of potential depreciation claim on goodwill going forward, the rule requires the taxpayers to pay taxes on excess depreciation claimed in the past on such goodwill by deeming the same as STCG in certain circumstances.

c. Non-Compete

Various High Courts and income-tax tribunals have taken differing opinions on the issue of depreciation of non-compete fee. The Mumbai Bench of the Income Tax Appellate Tribunal, in Ind Global Corporate Finance Private Limited vs. ITA,[14] has held that non-compete fees paid for a non-compete obligation of thirty six (36) months, was not in the nature of revenue expenditure, but in the nature of a capital asset and was eligible for depreciation. The court held:

> *"... that by obtaining non-compete right on payment of non-compete fee, the assessee can run his business without bothering about competition and, therefore, non-compete right was an intangible asset falling in the category of any other business or commercial right under Section 32(1)(ii) ..."*

13 Rule 8AC of ITR.

14 MANU/IU/1153/2012.

The court relied on the judgments in *ACIT v. Real Image Tech Private Ltd.*[15] and *Scott Glass India Tech. Private Ltd. v. Deputy CIT*[16] while holding that depreciation would be allowable to an *assessee* on acquisition of a non-compete right.

Similarly, the Madras High Court, in the case of *Pentasoft Technologies Ltd. vs. the Deputy Commissioner of Income Tax*,[17] while considering a composite agreement for the transfer of software and training divisions of a business to the assessee, including copyrights, trademarks, and non-compete rights, observed that the non-compete clause in the agreement must be read as a supporting clause to the transfer of copy rights and patents. Therefore, the Court herein, while taking the non-compete right to be a commercial right similar in nature to patents, copyrights etc., held that such non-compete right is eligible for depreciation in terms of Section 32(1)(ii) of the ITA.

However, a contrary view was taken by the Delhi High Court in *Sharp Business System vs. The CIT.*[18] In the said case, the Court denied depreciation on the non-compete fee paid as in the court's opinion the payment for non-compete did not represent any business or commercial right. The court opined that a non-compete was a right *in personam, as opposed to know-how or license or franchise, which were rights "in rem". Furthermore, the* court held that the amount paid was not eligible for depreciation as an intangible asset as it was a non-transferable personal right capable of being enforced only against the covenanter. In this context, please refer to the table below on the differences that arise in characterization of the excess payment as non-compete fee or goodwill.

Particulars	Goodwill	Non-compete
Enforceability of Non-compete under the Indian Contract Act, 1872	Buyer should categorize as much consideration to goodwill as possible to ensure that the maximum extent of non-compete is available.	Allocation of consideration to non-compete shall not have any bearing on the enforceability of the non-compete provisions.
Revenue Expenditure for Buyer	Courts have held that goodwill is in the nature of a capital asset; hence deduction as revenue expenditure may not be permissible.	Courts have had differing opinions on the characterization of the expenditure as revenue or capital. In certain cases, where the courts believe that the non-compete fee does not bring into existence an asset or advantage of an enduring nature, the courts have permitted non-compete fee as revenue expenditure for the buyer. However, if the non-compete fees is of enduring nature and central to the transaction, it is likely that it shall be classified as a capital asset, and disallowed as a revenue expense.
Depreciation Benefit	Depreciation benefit not available on goodwill	Depreciation benefit is likely to be availed by the buyer. In the case of Ind Global Corporate Finance Pvt. Ltd., it was held that depreciation will be allowed on non-compete expenditure as a non compete right was held to be an intangible asset. It was further held that if the payment of a non-compete fee was for a right that would be valid for sufficient length of time (3 years in the abovementioned case) the expenditure would be capital in nature. However, there have been contrary views expressed in case laws.[19]
Treatment for Seller	The income is likely to be treated as capital gains income.	The income may be treated as business income if the non-compete fees received does not form an integral part of the slump sale transaction by virtue of Section 28(va) of the ITA.
GST	No GST should be payable.	GST should be payable at the applicable rate.

15 [2009] 120 TTJ 983 (Chennai).

16 ITA No. 1698/Mum/2003.

17 [2014] 222 TAXMAN 209 (Mad).

18 ITA 492 of 2012,

19 ibid.

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Having said that, as a compromise, the buyer and the seller may agree to not attribute a separate consideration to non-compete payments or goodwill but at the same time clearly mention in the business transfer agreement that the seller acknowledges that the consideration for business transfer is sufficient for him to comply with the obligations of non-compete under the Agreement.

C. Section 281 Certificate

According to Section 281 of the ITA, when during the pendency of any income tax proceeding or where the proceedings have been completed but notice thereunder has not been issued, the seller creates a charge on or parts with the possession, whether by way of sale, mortgage, gift, exchange or any other mode, of any of his assets in favour of any other person, such charge or transfer shall be considered void as against a claim in respect of any tax or any sum payable by the seller as a result of the completion of the said proceeding. Essentially, Section 281 of the ITA imposes an overriding charge on an assessee's assets for all pending income tax dues, whether crystalised or not. Any assessee wishing to transfer any assets covered by Section 281 of the ITA, must first obtain permission from the income tax department (assessing officer) to do the aforesaid. However, where the transfer is made for adequate consideration and without notice of the pendency of such proceedings or sum payable or where the prior permission of the tax authorities is obtained, any such charge or transfer would not be regarded as void.

The object of this provision is to prevent taxpayers from encumbering or selling off their assets in order to avoid paying taxes.

Additionally, as mentioned above, the ITA also allows the taxpayer to apply to the tax authorities for permitting the proposed transfer of assets. A circular[20] issued by the CBDT lays down the relevant rules and procedures in connection with such application. The circular requires the transferor (taxpayer) to apply for the permission at least 30 (thirty) days prior to the proposed date of transfer. In light of the provisions of Section 281, it is important for the buyer to ensure that the seller procures this permission from the tax authorities as a condition precedent to the slump sale. Though the certificate required under Section 281 does not in any way mean that the tax authorities cannot assert any tax claim against the seller, however a certificate under Section 281 of the ITA should lend some degree of comfort to the buyer that the business sale itself will not be declared void.

There is, however, an ambiguity on the applicability of Section 281 of the ITA to slump sale transactions. The explanation to Section 281 of the ITA provides that "in this Section, 'assets' means land, building, plant, securities and fixed deposits in banks, to the extent to which any of the assets aforesaid do not form part of the stock-in trade of business of the assessee." While, the explanation to section 281 does not explicitly cover an undertaking, in case any of the specified assets mentioned in the explanation are transferred as a part of the undertaking in slump sale, one may argue that provisions of section 281 apply to such transfer.

20 Circular No. 4/ 2011 (F.No. 402/69/2010/ITCC)

D. Liability Under Section 170 of the ITA vis-a vis Section 281 of the ITA

Section 170 of the ITA deals with the liability of a successor to business or profession and specifies that the successor to any business shall be assessed in respect of the income of the previous year in which the succession took place, from the date of succession. The liability imposed on the successor under this Section also extends to assessment of income prior to the date of succession, in case the predecessor cannot be found by the tax authorities.

The significant question that arises here is whether an authorization under Section 281 of the ITA (as described in detail above) absolves the buyer from being treated as 'successor in business' under Section 170 of the ITA and the answer is clearly in negative. Sections 281 and Section 170 being two mutually exclusive provisions, the liability under Section 170 is not in any way mitigated merely by virtue of a Section 281 certificate. This is because, Section 281 of ITA only validates a transfer of assets, undertaken during the pendency of any income tax proceedings, whereas Section 170 creates a liability in favour of a successor of business.

E. Section 56 of the ITA

According to section 56(2)(x) of the ITA, where any person, receives any property from any person without consideration or at a consideration which is less than the FMV of such property, the difference between the consideration and the FMV of such property is taxable under head 'income from other sources' in the hands of transferee.

Section 56(2)(x) is any anti-abuse provision, the object of which is to prevent taxpayers from selling off their assets without consideration or for inadequate consideration.

There is, however, an ambiguity on applicability of Section 56(2)(x) to slump sale transactions. The term 'property' has been defined to mean a capital asset of the assessee namely *inter-alia* immovable property being land or building or both, share and securities, jewelry, paintings and any work of art. While, the definition of property does not explicitly include an undertaking, in case any of the specified assets mentioned in the definition of property are transferred as a part of the undertaking in slump sale, possibility of income-tax authorities arguing applicability of Section 56(2)(x) of the ITA based on the purchase price allocation cannot be ruled out. It may be argued that this approach may go against the whole concept of taxation of slump sales, where a lump sum consideration is paid for the entire business as compared to assigning of values to individual assets acquired as part of the business.

F. Employee Transfer

One of the most critical aspects of slump sale deals is structuring transfer of employees from the seller to the buyer. Infact, more and more transactions are occurring due to well-trained, experienced and talented resources being readily available as part of the transaction, with a premium being attached to them.

While it is primarily significant for the buyer to understand the categorization of employees of the seller in relation to the transferred business in terms of workmen and non-workmen, it is equally important from a purely HR perspective to conduct a thorough HR diligence of the seller, its personnel policies, terms and conditions of employment, benefits etc. Post-merger integration assumes greater significance in such situations.

As per Section 25-FF of the Industrial Disputes Act, 1947 (**"IDA"**), the employment of a workman may be transferred from one company to the other, in case of transfer of ownership or management of an undertaking, subject to the fulfillment of all the following three conditions:

a. The workman's service should remain uninterrupted as a result of the transfer;

b. The new terms and conditions of service applicable to the workman after the transfer should not in any way be less favourable than those applicable to him immediately before the transfer; and

c. For the purposes of calculating retrenchment compensation (severance), the workman's previous years of employment with the transferor company should be recognized.

In case any of the above three conditions are not met it would be treated as retrenchment (termination of employment) by the employer, triggering a notice and severance payment requirement in compliance with applicable law. There have also been some case laws surrounding the question of whether the workmen's consent is requiring for transferring their employment, something that may be considered at least as a best practice and/or possibly giving the buyer an opportunity to execute new employment contracts. Typically, the aforesaid principle of transfer and the terms of employment of each of the employees proposed to be transferred to the buyer is recorded in a tri-partite employment transfer letter executed between the buyer, the seller and each of the identified employees. However, the seller continues to be liable after the transfer date, for all pre-closing employment related liabilities (except to the extent of leave encashment, gratuity and bonus already paid / adjusted in the purchase consideration relation to the transferred employees). Alternatively, another mode of transfer of employment from the seller to the buyer could be by way of resignation and re-hire, where the employees resign from the seller and enter into an employment relationship with the buyer.

It must be noted that the IDA applies only to employees categorized as workmen.[21] For non-workmen category employees, there is generally greater flexibility in transferring their employment, although again there may not be a need to deviate from the above conditions.

Post-merger integration assumes greater significance in situations where human resources are an important component of the slump sale. The parties shall be required to comply with the applicable laws, employment contracts and HR policies in relation to transfer of benefits (such as leave encashment, bonus and gratuity), transfer of provident fund accounts, insurance coverage, alignment of HR policies and benefits, as part of some of the initial HR related considerations. Also, there could be situations where some employees are not required to be transferred as part of the slump sale, in which case their employment may need to be terminated in compliance with applicable laws.

21 Please refer to Section 2(s) of the IDA for definition of workmen.

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G. Nature of Assets

Some of the typical assets involved in a business transfer are as follows:

1. Contracts (customer and supplier purchase orders, long term agreements, land leases etc.)
2. Licenses/ registrations, permits etc. (to the extent they are transferrable and not entity specific)
3. Immovable property

To deal with each of the items in detail:

I. Contracts

The contracts which are essential to the conduct of the transferred business generally include customer contracts, supplier contracts, lease deeds/ leave and license agreements for premises used in connection with the transferred business.

While transferring the contracts, it is important to ascertain whether the existing contracts pertaining to the transferred divisions) contain an 'assignability' provision, in which case, the contracts can merely be assigned by the seller to the buyer by way of a new instrument (either deed of assignment or otherwise). However, in case the contracts are not assignable, then the next suitable alternative is to (i) terminate the existing contracts between the seller and the third party; and (ii) the buyer enters into fresh contracts with such third party. It is crucial for the buyer to establish effective communication with the customers and suppliers before finalizing the terms of the business transfer. It is also important to determine whether existing contracts with third parties require a no-objection prior to effecting the business transfer. This proactive step ensures that all relevant parties are well-informed about the impending change in ownership and have no-objection for the same.

it is not uncommon to find business relationships that are not documented in the form of written contracts but are rather based on purchase order/ supplier order basis. In such cases, it is important for the buyer to liaise with the customers/ suppliers prior to closing such that the customer/ suppliers are duly informed about the business transfer. Though it is recommended that tri-partite agreements may be signed between the buyer, seller and the customer/ supplier to record the understanding, yet it may not be possible in all cases for the customers/ suppliers to agree to sign such agreements, in which case one-on-one meeting between the buyer and each of the customers/ suppliers (or at least those which constitute 95% of the revenue of the transferred business) may be organized by the seller.

Sub-Contracting Arrangements Between the Seller and the Buyer

As a matter of common practice, we find that the parties do not intend to disturb the continuity of service levels and perturb the customers by informing them about the business transfer, in which situations, the buyers enter into sub-contracting arrangements with the sellers. These sub-contracting arrangements are resorted to especially in cases where the existing contracts in relation to the transferred business are not assignable or transferable to the buyer. In such arrangements, the buyer acts as the sole sub-contractor for the seller in terms of execution of the non-assignable contracts, in return for the consideration being passed on from the customer to the buyer through the seller.

II. Licenses/ Registrations, Permits

The parties to a slump sale should prepare a list of all registrations/ permits that the seller has procured and maintained in relation to the transferred undertaking and it is important to check if the existing licenses/ permits etc. procured by the seller are valid and existing at the time of closing. Most of these licenses are not transferrable/ assignable and it is thus important to ascertain the same while conducting the due diligence, so that the buyer can prepare itself for taking such registrations in its own name.

III. Immovable Property

In case of transfer of any immovable property from the seller to the buyer as part of the business transfer, it is important to ensure that a proper title diligence is conducted on all those properties proposed to be transferred. For diligence of the title, the usual course is to verify the local revenue records (with a look back of 30 years) besides conducting a search on the website of the Ministry of Corporate Affairs, so as to ensure that the immovable property in question is free from any kind of charge or encumbrance. Only after getting a clear title report, should the buyer agree for taking over such immovable properties. In case of transfer of immovable property, the seller shall execute a fresh conveyance deed in favour of the buyer and undertake necessary formalities for registration of the conveyance deed. The parties may assign appropriate values to the deeds of conveyance or any other deeds and documents for the discharge of specific statutory liabilities, including stamp duty and registration charges, if applicable. Such indication of value of the property in the respective deeds or documents entered into by the parties, is not deemed or construed as allocation of purchase price by the parties to individual or identified assets or liabilities of the transferred business.

Transfer of assets in the nature of immoveable property may possibly result in income arising out of capital gains in the hands of the seller and liable to tax at the applicable rates.

H. Conclusion

The decision to opt for purchase of the entire company or purchase of relevant assets or undertaking of the target company has always been a subject of debate. Such discussion was traditionally centered around the need for having an Indian entity to up-stream their costs, tax leakages and the unwillingness on the part of the Buyer to acquire businesses that may not be in line with its strategy. In the recent times, various global corporations have been more keen to inherit clean and transparent businesses without getting involved in the historical liabilities and the exhaustive due diligence process. With an increased focus on ethical governance and reputational risk being pegged at a much higher pedestal than financial risk and losses, the issue of 'what you inherit' is becoming critical. Moreover, the introduction of PN3 is leading the parties to explore other structure options since a share purchase does not work well within the contours of PN3, if that applies.

Having said that, each structure involves its own respective sets of merits and challenges. Whilst we have tried to list out most of the considerations that one should typically consider while evaluating the mode and manner of acquisition from a legal, tax and regulatory perspective. We have also tried to set out certain commercial and practical challenges, the strategy for acquisition that needs to be considered carefully based on other parameters as well such as the Indian anti-trust laws, investments through intermediate jurisdictions etc.

5. Challenges in a Business Transfer

We encourage you to please go through our research paper titled '**Mergers and Acquisitions in India**' for a more detailed analysis of some of these aspects.

July 2023

Mergers & Acquisitions

An India Legal, Regulatory and Tax Perspective

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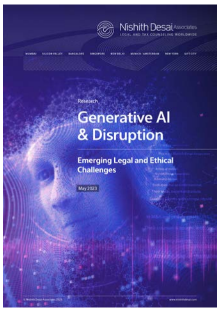

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LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI

93 B, Mittal Court, Nariman Point
Mumbai 400 021, India

Tel +91 22 6669 5000

SILICON VALLEY

220 S California Ave., Suite 201
Palo Alto, California 94306, USA

Tel +1 650 325 7100

BENGALURU

Prestige Loka, G01, 7/1 Brunton Rd
Bengaluru 560 025, India

Tel +91 80 6693 5000

SINGAPORE

Level 24, CapitaGreen
138 Market St
Singapore 048 946

Tel +65 6550 9855

MUMBAI BKC

3, North Avenue, Maker Maxity
Bandra–Kurla Complex
Mumbai 400 051, India

Tel +91 22 6159 5000

NEW DELHI

13-H, Hansalaya Building, 15
Barakhamba Road, Connaught Place
New Delhi 110 001, India

Tel +91 11 4906 5000

MUNICH / AMSTERDAM

Maximilianstraße 13
80539 Munich, Germany

Tel +49 89 203 006 268

NEW YORK

1185 6th Avenue, Suite 326
New York, NY 10036, USA

Tel +1 212 464 7050

GIFT CITY

408, 4th Floor, Pragya Towers
GIFT City, Gandhinagar
Gujarat 382 355, India

Business Transfer
Why, How and When?

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concierge@nishithdesai.com