

Reverse Flipping of Start-Ups- Trend of the Future?

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I. Background

Indian start-up landscape is thriving and India is now home to 113 unicorns and is only behind the US and China in terms of number of unicorns.

The funding in the first quarter of 2024 has been on the lower side and some reports suggest that there has been a decline of 33% in the funding of start-ups on a year-on-year basis, however this trend is anticipated to be temporary and the funding is expected to pick up in the future years.

While the funding from the PE/VC funds have declined, an interesting aspect for the mature start-ups has been listing of equity shares on the Indian stock market. Few of the household names of the start-up industry have even been listed at good valuations, giving the initial investors significant upside on their exit.

II. Flipping of the structure

Flipping of the structure, refers to the process of transferring the ownership of the start-up from India to an overseas jurisdiction, through set up of a holding company in an overseas jurisdiction. Singapore was a very popular jurisdiction amongst the start-ups, followed by jurisdictions such as Mauritius, US and UAE.

The reasons for opting for such jurisdictions for housing the holding entity were ease of doing business through favourable regulatory regime, easier access to funding and favourable tax rates for start-ups.

III. Reverse flipping of the structure

In earlier years several start-ups had shifted their holding company to overseas jurisdictions, for the various reasons mentioned above. However, those start-ups who had undergone 'flipping' of the holding structure are now looking at 'Reverse flipping' of the holding company's jurisdiction to India.

Some of the reasons attributed to this trend are as follows:

- The Regulatory regime in India is improving and there are various schemes which have been announced by the Government to improve the ease of doing business in India for the start-ups.
- The corporate tax rates in India have been rationalized and further start-ups are provided tax incentives such as tax holiday under S.80-IAC^[1] of the Income Tax Act and concession for carry forward of losses under S.79^[2] of the Income Tax Act, which are incurred by a start-up in the initial years of the company.
- Access to funding in India has improved and many of the foreign investors as well as the PE/VC funds are comfortable with a structure where the holding structure is based out of India.
- Indian stock markets have given good valuations for start-ups which have been listed in the past and hence start-ups are increasingly considering going for an IPO to get listed on the Indian stock market.

IV. Mechanisms to achieve reverse flipping

While there are various methods to achieve the transfer of jurisdiction of the shares, in this section we shall discuss two methods which is being currently explored:

1. Share- swap method: In this method, the shareholders of the holding company will receive shares of the Indian holding company and the shareholders shall transfer their holding in the overseas holding company.

For instance, ABC India Ltd is a start-up whose shares are held by ABC Hold Co, which is based in Singapore. The shares of ABC Hold Co is majorly held by a PE firm.

In the above scenario, share swap can be achieved by transferring the shares of ABC India Hold Co (Newly set up holding company in India) to the PE firm and the PE firm shall transfer its shares in ABC Hold Co to ABC India Hold Co, post which ABC Hold Co shall be liquidated.

In the above scenario, there is likely to be a capital gains exposure for the PE firm which is likely to be taxed on the difference in the valuation of the shares of ABC India Hold Co and deducted by the cost of acquisition of the shares of ABC Hold Co.

Taxability shall also depend on the period of holding of shares and also another aspect to be looked at is whether there are any tax treaty benefits which can be explored.

Additionally, on change of ownership, there is a possibility that the start-up may not be able to carry forward the tax losses which may have been accumulated over a number of years, if the conditions of S.79 of the Income Tax Act are not met.

This option does not involve getting court approvals and can be achieved basis formal agreements between the parties, however the tax cost involved in executing this option shall have to be carefully considered.

2. Inbound merger: In this option the holding company, based in a foreign jurisdiction, shall merge with the Indian company and post-merger the Indian company shall be the surviving entity.

For instance, ABC India Private Ltd is a start-up whose shares are held by ABC Hold Co, which is based in Singapore. The shares of ABC Hold Co is majorly held by a PE firm.

In the above example, ABC Hold Co shall merge with ABC India Private Ltd, post which ABC India Private Ltd shall be the surviving entity. As a part of the merger, ABC India Private Ltd shall have to issue its own shares to the PE Firm.

If the above merger qualifies as an 'amalgamation' by satisfying the conditions of S.2(1B) of the Income Tax Act and if the conditions of S.47(vii) are satisfied, then the capital gains shall be exempt in India, for the PE Firm.

However, the merger shall require approval of NCLT and Foreign Exchange Management (Cross Border Merger) Regulations, 2018, issued under FEMA shall also have to be complied with. Further whether the merger is allowed in the overseas jurisdiction where the holding company is based, shall have to be ascertained.

While this option may result in tax savings, this option could take more time to achieve considering the Regulatory approvals involved.

V. Reverse Flipping and IFSC GIFT City as an option

Realising the trend of reverse flipping and to encourage the start-ups which have been domiciled outside India to revert the holding structures back to India, The International Financial Services Centres Authority (IFSCA) had come out with a report in August 2023, titled - 'Onshoring the Indian Innovation to GIFT IFSC', in which, the contribution of start-ups to the Indian economy and job creation has been

acknowledged and the need to encourage the start-ups to redomicile back to India has been highlighted.

The following extract from the report is helpful to highlight the above:

*“In order to avoid flipping/externalization of Indian startups, the report delves into the startup landscape, regulations and the forces shaping the future of this industry. Insights presented in this report, will highlight upon the reasons for flipping of Indian startups and suggestions that may be implemented to avoid externalization of startups in the future and **also to make an effort in order to persuade startups that are presently externalized to redomicile back to India.**”*

The Committee has identified several areas which, if amended can encourage the start-ups to domicile back to India. Some of the key recommendations from a taxation standpoint are as follows:

S No	Issue	Recommendation
1.	Residential status of foreign subsidiaries of GIFT company	In case of relocation of offshore holding company to GIFT IFSC, there should be no adverse tax consequences for the subsidiaries of GIFT IFSC holding companies merely because it is effectively managed in India via the IFSC holding company. This can be ensured by way of an express clarification that PoEM will not be triggered merely because the holding company is based in GIFT IFSC.
2.	Angel tax exemption	To encourage flipping of offshore holding company into GIFT IFSC and for that matter even to encourage greenfield investments in holding companies to be setup directly into GIFT IFSC, angel taxation provisions should not apply to GIFT IFSC holding companies.
3.	Transfer tax levied in offshore jurisdiction	For startups reverse-flipping into GIFT IFSC, the Government may consider permitting carry forward of the losses or provide enhanced tax holiday period instead of the existing 10 year tax holiday.
4.	Stamp duty exemption	To encourage startups to consider GIFT IFSC for set-up of holding company, stamp duty exemption should be provided.
5.	Exemption from 'deemed gift tax'	Tax exemption from applicability of 'deemed gift tax' under the provisions of section 56(2)(x) of the Income-tax Act, 1961 should be enacted for relocation of holding companies in GIFT IFSC.

VI. Comments

The trend of reverse flipping is gaining traction amongst various start-ups, especially for IPO bound

companies. Considering the buoyancy of the Indian stock markets, this trend is likely to become more prominent in the future.

While, from a commercial stand-point this trend is very attractive, there are various Regulatory and Tax aspects which have to be factored into, especially for start-ups with large valuations, considering the costs/ time involved in reverse flipping the holding structure could be significant.

The IFSCA recommendations cover a large number of challenges which the start-ups face today and if the recommendations are accepted by the Government, this could be a game changer for start-ups since GIFT City could become an option as attractive as some of the overseas jurisdictions which are considered by the start-ups.

[1] On satisfaction of certain conditions prescribed in the section

[2] For eligible start-ups as referred to in S.80-IAC