Reverse Flipping the Structure – To Do or Not To Do?

Introduction

Why are Indian origin businesses re-aligning their operations from foreign countries back to India? 'Reverse Flipping', as the term seems to suggest, is the process of restructuring the group's operations and capital structure, such that the holding company of the group becomes the Indian entity.

The last decade experienced a number of Indian businesses expanding into global jurisdictions; however, the trend has now reversed, and companies are bullish on the India growth story.

The optimism can be attributed to multiple reasons, including the evolving economic landscape of the Indian markets, simplified corporate laws, tax incentives, better exit opportunities and higher valuations, improving infrastructure and increased capital expenditure by the Government to fuel growth, etc.

The recent regulatory reforms and schemes by the Government of India have not only enhanced the ease of doing business in India but have also lured the India-based entities to revisit their home market. Attractive valuations and increasing interest in capital market investments by the Indian population may also pave the way for potential IPOs for companies who have shifted their holding structure to India – resulting in value creation and exit opportunities for early investors.

In the past few years, many Indian based businesses like Zepto, Groww, PhonePe, Urban Ladder and Pepperfry have undergone an internal restructuring exercise to flip the structure and have the group's operations controlled by an Indian holding company. Whilst this may appear to be easily implementable, the proposed group restructuring is bundled with tax and regulatory nuances that will need to be evaluated from both a host country and an India perspective, to successfully and efficiently implement the reverse flip.

Typically, the end objective of re-aligning operations from foreign jurisdictions to India can be achieved either through a merger of the foreign entity into an Indian entity or by way of swap of shares where the shareholders of the foreign entity receive shares in the Indian entity. In case of a merger, certain jurisdictions like Mauritius and Luxembourg permit an outbound merger, whereas jurisdictions like UAE, Japan, Australia, Canada, Singapore, and Hong Kong do not permit this outbound merger – thereby making the implementation of having an India holding company all the more challenging.

One would need to deep dive into the tax, regulatory and commercial considerations that may need to be evaluated prior to resorting to such internalization, be it through an inbound merger or a share swap. The regulatory implications for both the routes are briefly discussed below.

A. Merger

1. **Tax Implications:**
   In case of a merger, shareholders of the foreign entity would receive shares in the Indian entity as consideration for the merger. The tax considerations associated in an inbound merger are outlined below:

   a) **Tax Neutrality:** The Indian Income-tax Act (IT Act) provides tax neutrality for inbound merger (subject to fulfillment of certain conditions), extending this exemption to both the foreign company and its shareholders. The tax-neutrality for the foreign company and its shareholders is one of the key drivers for foreign companies to relocate to India through inbound mergers.

b) **Carry Forward of Losses:** Availability of carrying forward the tax losses of the foreign amalgamating company by the Indian amalgamated company may not be permissible as per the Indian tax laws given that such losses were incurred outside India and accordingly cannot be brought within the ambit of the Indian tax laws.

The eligibility of the Indian amalgamated company to carry forward its own tax losses would also need a careful evaluation, depending on its post-merger shareholding structure.

c) **Applicability of Anti-Tax Avoidance Laws:** GAAR is a tool for checking aggressive tax planning, especially for transactions/business arrangements, which are designed to obtain a tax benefit or lack commercial substance. Hence, these anti-tax avoidance provisions need to be borne in mind, whilst deciding upon the final structure.

d) **Exit Tax:** Evaluation of potential tax liabilities in foreign jurisdictions (including exit taxes in the foreign jurisdiction) is another important consideration.

e) **Inter-play of Tax Treaties and Permanent Establishment:** From a treaty perspective, one key aspect to be evaluated in a reverse flip structure is whether the Indian amalgamated entity triggers a Permanent Establishment in the foreign jurisdiction due to the continuation of assets (such as immoveable property, plant & machinery, office space, etc.) and /or employees in the foreign jurisdiction.

2. **Valuation & FEMA Interplay:**
A key aspect of the merger is to determine the share swap ratio i.e., the shares required to be received in the Indian entity by the existing shareholders of the foreign entity. The valuations of the foreign entity (amalgamating company) and Indian entity (amalgamated company) would need to be calculated by a merchant banker based on an internationally accepted valuation methodology and the share swap is determined accordingly.

Typically group restructurings such as reverse flips are effectuated to benefit from an economic, tax and regulatory climate and the commercial considerations are kept unchanged. In lieu of this, while determining the share swap, one must ensure that the resultant shareholding and control of the Indian entity post-merger is as per the commercial requirements and in line with the erstwhile shareholding and control held in the foreign entity.

3. **Host Country's Regulations:**
The feasibility of an in-bound merger would also depend on the host country's regulations and whether such mergers are permitted or not along with the tax and other regulatory implications arising for the company and the shareholders in the host country and the process/timelines for effectuating such mergers in the host country. Whilst Mauritius and Luxembourg are tax and regulatory friendly jurisdictions, such transactions have by and large remained untested till date.

4. **Other Regulatory Considerations:**

Foreign Exchange Regulatory Considerations:

(i) **FDI:** Needless to say, the transaction would also need to be compliant with Indian foreign exchange laws and be in accordance with pricing guidelines, sectoral caps, entry routes, (as applicable to foreign direct investments). For instance, under the FDI policy, prior Government approval may also be required for certain in-bound merger cases; say for a merger of a foreign company into an Indian company, sharing a land border with India, merger with an NBFC or banking company resulting in a change of control, etc.

(ii) **ECB:** One would need to evaluate the applicability of the RBI Master Directions on External Commercial Borrowings for all borrowings of the foreign company, which

stand transferred to the Indian amalgamated company pursuant to the merger.

Corporate Law Considerations: An in-bound merger entails a plethora of corporate law compliances. Effectuating an in-bound merger is a time-consuming and costly process. It requires multiple approvals in India and is a court driven process, with uncertain outcomes and elongated timelines.

Stamp Duty Considerations: An in-bound merger will attract stamp duty implications per the laws prevalent in the State in which the merger is sought to be effectuated.

B. Share Swap

The existing Group structure may entail a foreign entity holding 100% of the equity shares of the Indian entity. For commercial exigencies, the Group may desire to flip the current capital structure and have its shareholders (presently at the foreign entity level) to be shareholders of the India entity and have the foreign entity become a wholly owned subsidiary of the Indian entity. In order to achieve this, the Group could consider a share swap, entailing the following steps:

- **Secondary Acquisition:** Shareholders of the foreign entity to transfer their shares to another Indian group entity by way of a share swap (i.e. without consideration).
- **Primary Infusion:** Indian entity to issue shares to the foreign shareholders of the foreign entity as a consideration for the shares acquired.

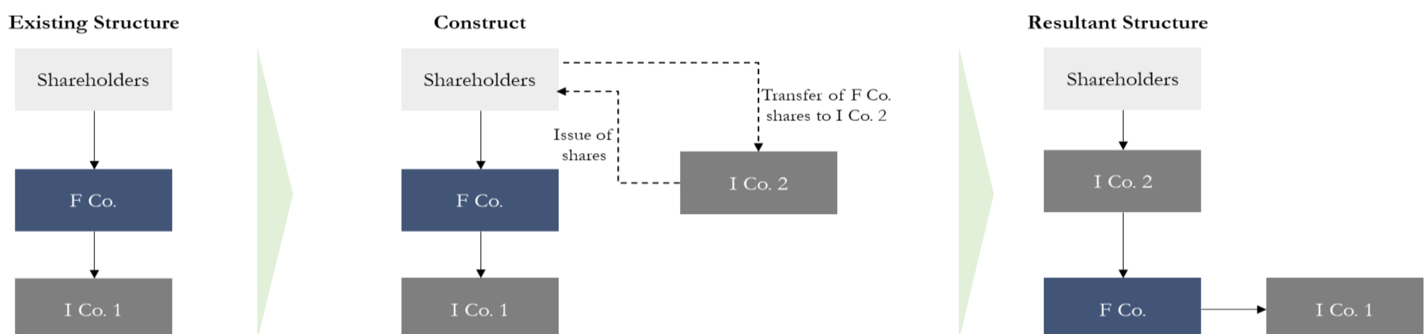
In essence, the valuation would need to be such that the commercial understanding between the shareholders remains the same, i.e. the same shareholding percentage in the foreign entity is mirrored in the Indian entity

1. **Tax Implications:**
Foreign shareholders would receive shares in the Indian company, in lieu of the shares held by them in the foreign company

Capital Gains: The foreign shareholders would be liable to pay capital gains tax in India on the value of shares received in the Indian company, as reduced by the cost of acquisition of shares held by them in the foreign entity. Further, the provisions of the Tax Treaty (if applicable) may also need to be evaluated to determine the taxability of capital gains.

Whilst the computation mechanism for the tax is clear, there are various ambiguities that may result in tax litigation in the future, primarily arising from the determination of the share swap ratio. Bridging the valuation requirement from a foreign exchange and tax perspective to ensure compliance with the regulations may be challenging, especially when non-resident shareholders are involved.

Angel Tax: Additionally, the angel tax provisions may also get triggered for I Co. 2 in the event of issue of shares in the Indian Company to the shareholders of F Co. at a premium and the key consideration here is to assess the ability of the Indian company to substantiate the premium element embedded in the valuation.



2. **Other Regulatory Considerations:**

Achieving the objective of internalizing through a 'share swap' may appear more appealing vis-à-vis an inbound merger, since the transaction may be effectuated within a much shorter time frame and that too without any regulatory approvals.

The share swap also eliminates the dependence on the foreign jurisdiction's regulatory climate vis-à-vis a merger.

Foreign Exchange Regulatory Considerations:

(i) **Share Swap:** However, effectuating share swap transactions comes with its own set of regulatory challenges. As mentioned earlier, the share swap would involve two legs - a secondary transfer of shares by the shareholders of the foreign entity to the Indian company and a primary issue of shares by the Indian company to the shareholders of the foreign entity. The valuation arrived at would need to be in sync with foreign exchange laws that require issue of shares by an Indian entity to non-residents to be at an arm's length price and essentially at a price not lower than the fair value of the Indian entity.

(ii) **Reverse Share Swap:** It is also pertinent to note that under the extant foreign exchange regulations, a reverse share swap (i.e. wherein the foreign entity is proposed to be made the holding company of the Group and the Indian shareholders have to swap their shares in the Indian entity with the shares of the foreign entity) is not permissible under the Automatic Route. Prior Government /RBI approval would therefore be required for this reverse share swap.

CNK Comments

It is only in recent years wherein the trend of companies opting to shift their holding structure to India has picked up. Opportunity to tap into a large pool of capital (including a potential IPO) coupled with attractive valuation in Indian markets have been the key drivers for companies evaluating and implementing a reverse flip transaction.

A huge untapped pool of domestic capital from HNIs, venture capital and private equity Funds, amongst others is readily available, since investors are bullish and believe in the India growth story. The growing Indian economy also presents various opportunities to synergize operations with other domestic companies, in terms of a strategic alliance, joint venture, etc.

Apart from the benefits, certain commercial considerations including amendment to shareholder agreements and re-issue of stock options by the Indian company to its employees would need to be dealt with. This may create heart-burn for some employees since the stock options would be re-issued as per Indian laws and the foreign stock options granted, if any would stand cancelled. Such issues would need to be dealt with strategically to prevent attrition and ensure continuity and retention of talent.

Given that transactions in the nature of a reverse flip are considerably nascent, the various tax and regulatory implications that may arise are still untested and only time will tell whether a reverse flip to India can be effectuated seamlessly and efficiently – paving the way for many more companies to consider India as their home base.

In our experience, the facts of each case need to be evaluated in detail to identify the most effective and efficient way of structuring the reverse flip – i.e. either through an inbound merger or share swap.

To summarize, the crux of successfully effectuating the share swap lies in first aligning the commercial interests of the shareholders in both the Indian and foreign entity and then further ensuring that this commercial alignment is in sync with the Indian regulatory requirements (particularly FEMA/TAX) – a task easier said than done!

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