Reverse Flipping: Homecoming for the Indian Startups

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1. Introduction

Pepperfry, PhonePe, Pine Labs, Groww—guess what's common between them? Not only are all of them established start-ups, a testimony to the entrepreneurial spirit of Indian youth, but they have also recently moved their headquarters to India. Similarly, other fintech companies like Meesho, Flipkart, KreditBee, Zepto, and many others are looking to move their domicile to India.

The Indian startup landscape (the world's third-largest startup ecosystem[1]) has, in recent times, been the beneficiary of a multitude of policy reforms encompassing both tax and regulatory aspects. On January 16, 2016, the Indian government launched the Startup India scheme, aimed to build a robust ecosystem for fostering innovation and startups in the country, thereby driving economic growth and creating large-scale job opportunities. Accordingly, the Department for Promotion of Industry and Internal Trade (DPIIT) issued a notification granting recognition to startups that meet certain conditions, entitling them to a variety of benefits. Since the inception of Startup India, the DPIIT has recognised 143,945 entities.[2]

For any start-up to thrive, robust availability of funding is the key to survival and success. Despite several measures, these nascent Indian start-ups have traditionally faced a dearth of options for raising funds from angel investors or from the sophisticated investor class and options for exiting via listing of their shares on recognised stock exchanges. To ease such impediment, a prevalent strategy among Indian startups has been to establish their holding company in a foreign jurisdiction, a practice colloquially referred to as 'flipping'.[3]Flipping confers numerous advantages, including the ability to list on overseas stock exchange[4], attract a larger investor base, access to foreign capital via offshore Venture Capital who hitherto have shied away from India, garner higher valuations in foreign markets, enhance brand positioning, increased IP protection, navigate regulatory requirements with ease, align with founder preferences, and avail tax benefits. The jurisdictions favoured for flipping encompass Singapore, the United Arab Emirates, the Netherlands, Luxembourg, the Cayman Islands, Mauritius, the United States, and the United Kingdom.

Owing to the buoyancy of the Indian capital market, increased ease of capital accessibility through hybrid and sophisticated instruments, and a favourable tax and regulatory regime, 'reverse flipping' or 'internalisation' has recently emerged as a coveted strategy for Indian startups, particularly those operating in the fintech industry. Reverse flipping entails the relocation of an Indian company's ownership and value from an overseas jurisdiction back to India, a strategic manoeuvre often undertaken to address tax or regulatory concerns. The decision to undertake a reverse flip is influenced by a multitude of factors, including India's burgeoning economy, the availability of promising venture capital, an improved regulatory regime, robust intellectual property protection, a young and educated workforce, and, most significantly, listings of new-age startups in the Indian stock market. This paradigm shift presents a promising opportunity for companies to flourish in the Indian business milieu, offering potential benefits such as enhanced valuations[5] and a more favourable regulatory environment.

Techniques of Reverse Flipping

2.1. Inbound Merger

- **Architectural Framework/ Structural Design**

An inbound merger is characterised by the fusion of a foreign holding company with its Indian subsidiary. In essence, it denotes a scenario where the foreign holding company, acting as the amalgamating entity, integrates with its Indian subsidiary, the resultant entity.

- **Tax Consequences**

The foreign amalgamating entity and its shareholders can avail of an exemption from capital gains tax emanating from this transfer,[6] provided the transaction satisfies the criteria for being classified as an 'amalgamation' under the Indian Income-tax Act, 1961 ("IT Act").[7] Within the purview of the IT Act, the term 'transfer' encompasses the extinguishment or relinquishment of capital assets.[8] Structured appropriately, a cross-border merger can be tax-neutral in India, i.e. there may be no tax implications in the hands of the amalgamating company and its shareholders on the merger. Failure to do so may result in an extinguishment of shares of the foreign entity held in the Indian entity and trigger capital gains implications. Similarly, there could be tax implications in the hands of the shareholders (holding shares of a foreign company) wherein shares in the foreign company are exchanged for shares in the Indian company.

An Indian start-up having significant accumulated business losses may not prefer this route since its losses will lapse owing to a complete change in shareholding.[9] However, this restriction does not extend to Start-ups recognised by the Department for Promotion of Industry and Internal Trade ('DPIIT'). One should also be mindful that there is no mechanism under the IT Act to subsume the foreign tax losses (computed outside the purview of Income tax laws) post-merger with the amalgamated Indian company, and thus, the losses of the foreign company would also be a sunk cost.

- **Regulatory Provisions**

The regulations presiding over inbound mergers are delineated in Section 234 of the Companies Act, 2013 and the Companies (Compromises, Arrangements and Amalgamations) Rules 2016. Pertaining to these provisions, cross-border mergers necessitate the sanction of the Reserve Bank of India ("RBI").[10] However, in 2018, RBI promulgated cross-border merger regulations, stipulating that a cross-border merger will be deemed as approved by RBI if they are undertaken in consonance with the said regulations.[11] These conditions encompass complying with the pricing guidelines, entry routes, sectoral caps, attendant conditions, and reporting requirements for foreign investment as outlined in Foreign Exchange Management (Non-debt Instruments) Rules, 2019. The Cross Border Regulations also mandate all foreign company guarantees and outstanding borrowings that transform into the resultant entity's borrowings to adhere to external commercial borrowing/trade credit norms or other foreign borrowing norms within two years of the inbound merger.[12]

It is imperative to note that in addition to Indian regulations, due consideration must also be accorded to regulations of foreign jurisdictions. For instance, the regulatory laws of several jurisdictions like Singapore and the Netherlands do not permit outbound mergers. However, it would be interesting to note that PhonePe recently received approval from the Singapore court to merge its Singapore entity with its Indian entity, effectively reverse-flipping the company back to its home turf. Another pertinent consideration is the time required to consummate the reverse flip transaction. If the companies intend the reverse flipping to be tax-neutral in India, then it would be mandatory for it to follow the long-drawn merger process and secure statutory approvals from various regulators. In this context, other methods, such as share swaps, may be contemplated, as elucidated in the ensuing paragraphs. Business, if any, carried on by the foreign company will thereafter continue as a branch of the Indian company.

2.2. Share Swap

- **Structural Design/ Architectural Framework**

A share swap transpires when shareholders of a foreign company exchange their stake in the foreign entity for shares in the existing Indian company. Alternatively, the shares of the foreign company could be exchanged for a newly established Indian company, which subsequently assumes ownership of the foreign company. As a next step, the foreign company undergoes liquidation, and its assets are transferred to the Indian company. This process, when compared to a cross-border merger, is less time-consuming but necessitates a meticulous analysis of the regulatory practices of both Indian and foreign jurisdictions.

- **Tax Ramifications**

A share swap fulfils the definition of 'transfer'[13] as it incorporates the 'exchange' of shares within its scope. Furthermore, provisions pertaining to offshore indirect transfer tax[14] must be meticulously analysed to determine the tax liability, if any, of foreign investors (in India) if the shares of the foreign company derive substantial value from underlying assets situated in India. This method is commonly explored by investors who had established these offshore structures prior to April 1, 2017, wherein with some FDI partners (like Mauritius and Singapore), India had a favourable tax treaty network and permitted residence-based taxation as against source-based. For instance, if investment in shares of a foreign entity was done prior to April 1, 2017, investors from Singapore can claim an exemption under the tax treaty (subject to it being able to demonstrate that the company is eligible for availing treaty benefit).

- **Regulatory Considerations**

A critical regulatory approval to evaluate is the necessity of obtaining prior approval from the Government of India if the entities in question are involved in a business or sector that necessitates prior approval under the Foreign Direct Investment (FDI) Policy. For instance, the approval of the Reserve Bank of India (RBI) or the Department of Economic Affairs may be required for an inbound merger involving pharmaceutical companies, telecom, and defence.[15]

India formulates its Foreign Direct Investment Policy ('FDI Policy') periodically to regulate foreign investments in India. Under the FDI Policy, foreign investments in India can be made either under the automatic route or the government route. In this context, the Indian Government issued Press Note 03 of 2020 stipulating that investment from all countries sharing land borders with India will be under the government route, with a view to curb opportunistic takeovers/acquisitions of Indian entities. Consequently, the FDI policy was amended in 2020 to reflect this change. Thus, transactions involving reverse flip may require prior approval in case foreign investors are located in neighbouring countries.[16]

It should be noted that the methods discussed above are indicative and not exhaustive, and reverse flipping can be accomplished by employing other methods as well, such as reduction in share capital, and direct stake sale, which may necessitate a separate analysis of the tax and regulatory framework.

3. The Driving Forces Behind the Adoption of Reverse Flipping

• The Abolition of the Angel Tax

The recent abolition of the angel tax, as introduced by the Finance (No. 2) Bill, 2024, serves as a incentive for companies to consider reverse flipping. Historically, angel tax posed a considerable tax burden on Indian companies especially if the consideration received by it on the issuance of new shares exceeded its fair market value. However, startups recognised by the DPIIT have been exempted from this burden since 2019.[17] The repeal of this tax alleviates the surrounding tax compliances and the anxiety around fair valuations being challenged in tax audits. This also cultivates an environment conducive to capital raising within the country, rendering the investment climate more attractive to domestic investors.

• Favourable Conditions for the Technology Sector

India has been carving out a niche for itself as a global technology hub, providing a favourable environment for technology companies. India boasts an extensive pool of highly skilled technology professionals, enabling companies to recruit top-tier talent at competitive prices. The recent thrust towards artificial intelligence and blockchain development, coupled with initiatives such as Digital India and Startup India, have fostered a conducive environment for technological innovation and expansion. Significant investments in digital infrastructure, including broadband connectivity and smart cities, further augment the operational capabilities of technology companies.

• Efficient Regulatory Compliances

The Indian government has been steadfast in its endeavour to streamline regulatory compliances, thereby facilitating the business processes for companies. The government's unwavering commitment to regulatory reforms is manifest in India's significant ascension in the World Bank's Ease of Doing Business index. The deployment of digital platforms for regulatory filings and compliance mitigates paperwork and optimises processes, thereby conserving time and curtailing operational overheads for businesses. A significant initiative in this domain has been the implementation of single-window clearance systems for a multitude of approvals and licenses, which expedite business operations and curtail bureaucratic hurdles.

• Maturity of the Indian Initial Public Offering (IPO) Market

The Indian IPO market has witnessed substantial growth, proffering companies' lucrative opportunities to amass capital. The sector's robust performance has ignited an escalating interest among domestic and international investors in Indian technology stocks. Furthermore, the Securities and Exchange Board of India (SEBI) has instituted a variety of measures to expedite the IPO process, such as curtailing approval timelines and streamlining processes. Additionally, the positive performance of recent IPOs (in 2022, Indian stock exchanges ranked third in the world in terms of the number of IPOs[18]) has bolstered investor confidence and incentivised additional companies to consider public listing as a viable option for raising funds and achieving liquidity.

4. Conclusion

Reverse flipping presents a strategic opportunity for companies to capitalise on the favourable business environment in India. The burgeoning IPO market streamlined regulatory compliances, a conducive ecosystem for the tech sector, and a relatively stable and investor tax-friendly regime serve as potent incentives for businesses to revert to their roots and capitalise on the growth potential within the country. The growing weak U.S. labour market data and the rising geopolitical tensions also present the Indian capital markets with a unique opportunity to show resilience and deliver investor returns. The timing presents a unique opportunity for the Indian regulators to take cognisance of this trend and further liberalise modes of capital infusion in India to nurture the Indian startups. .

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1 Startup Ecosystem in India: Quick Facts, Startup India, https://www.startupindia.gov.in/content/sih/en/international/go-to-market-guide/indian-startup-ecosystem.html (accessed August 01, 2024).
2 https://www.startupindia.gov.in/content/sih/en/startup-scheme.html (accessed August 05, 2024)
3 Refer Box XI.5: 'Flipping and Reverse Flipping: the recent developments in Start-ups', the Economic Survey 2022-23, which reads as "Flipping is the process of transferring the entire ownership of an Indian company to an overseas entity, accompanied by a transfer of all IP and all data hitherto owned by the Indian company."
4 Currently, Indian regulations do not permit an Indian company to list on overseas stock exchange. A few years back, SEBI had formed a committee to look at the possibility of allowing Indian companies to list abroad and foreign companies to list in India. The proposals were shot down on concerns of flight of capital triggered by foreign listings.
5 Enhanced valuations connote inflated valuations in case of prominent startups such as Byju, Paytm, Nykaa and Zomato. These startups saw a ripple in the stock market at the IPO stage.
6 Section 47(vi) and (vii) of the IT Act, introduced vide Finance (No. 2) Act, 1967.
7 Section 2(1B) of the IT Act
8 Section 2(47)(ii) of the IT Act
9 Section 79 of the IT Act
10 Rule 25A of the Companies (Compromises, Arrangements and Amalgamations) Rules 2016.
11 Regulation 9(1), Foreign Exchange Management (Cross Border Merger) Regulations, 2018.

[12] Regulation 4(3), Foreign Exchange Management (Cross Border Merger) Regulations, 2018.
[13] Section 2(47(i) of the IT Act
[14] Section 9(1) of the IT Act
[15] Refer Schedule I of Foreign Exchange Management (Non-debt Instruments) Rules, 2019.
[16] Press Note-3 of 2020 made it mandatory for investors from countries with land borders with India to seek government approval to invest into India. The Economic Survey 2023-24 argues in favour of India considering foreign direct investments from its northern neighbour to boost exports, cashing in on the China-plus-one strategy playing out globally. The Finance Minister in her post Budget speech stated that the Government will consider the suggestion.
[17] Notification No. G.S.R. 127(E) dated February 19, 2019 issued by the Department for Promotion of Industry and Internal Trade
[18] https://www.ey.com/en_in/ipo/india-ipo-trends-report