RESOURCES

Reverse Flipping: Time To Internalise Into India Inc

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- Another factor contributing to this trend is the changing attitude of founders / management, and its direct proportionality to an attractive near-future exit by way of an IPO
- Here are some important considerations for entities, their management, and participating shareholders to analyse in case of an internalization

Reverse flipping refers to the process of *internalising* through an integration of ownership and value of an entity back into India.

The foreign and Indian shareholders exchange their shares held in the foreign holding company for shares in the Indian company, pursuant to which the foreign companies/offshore holdings are dissolved or merged into the Indian entity and all the shareholders at the offshore level own the shares of the Indian entity.

General motivation for a reverse flip is the increased certainty of an exit at a higher valuation in India. Established companies such as PhonePe and Pepperfry have recently internalised into India – which only demonstrates the increasing popularity of this process.

The Economic Survey 2022-23 has observed that there is a conducive environment for an increase in internalisation into India due to various initiatives, reforms and schemes targeted towards startups by the Indian Government, greater access to capital within the prevalent private equity and venture capital setup, the growing maturity of Indian markets and the recent changes in rules regarding round-tripping.

Another factor contributing to this trend is the changing attitude of founders/management, increased investment interest, brand relationships fostered and strength of the customer base in India and its direct proportionality to an attractive near-future exit by way of an IPO.

In the face of global challenges, steep fall in valuations of new-age tech firms, and funding uncertainties, returning to India can lead to more beneficial business operations and reduced administrative overhead.

Key Considerations In Respect Of Reverse Flipping

Important considerations for entities, their management, and participating shareholders to analyse in case of an internalization include:

Structure

It is crucial to select the right structure to meet the legal, regulatory and tax requirements in the jurisdiction(s) involved. Structuring options include in-bound mergers or share swap arrangements, each with its set of complexities and regulatory requirements. Approvals from the National Company Law Tribunal in India and compliances / actions under the applicable laws of the host country need to be evaluated.

ESOPs

ESOPs may need to be factored in and structured according to Indian corporate laws and foreign investment rules.

Tax Implications

The tax implications vary depending on the chosen structure. In in-bound mergers, shareholders may be able to claim exemptions from capital gains tax if it qualifies as an 'amalgamation' under the Indian Income Tax Act, 1961 ("**IT Act**") and subject to certain conditions. In case it does not qualify as an 'amalgamation', capital gains upon cancellation of shares of the shared held by the foreign entity in the Indian entity may also be taxable in the hands of foreign entity.

However, if the reverse flip involves a swap of shares held by the foreign shareholders in the foreign entity with the shares of the Indian entity, it will be subject to tax in India on the delta between the value of shares of the Indian entity at the time of such reverse flip and the cost of acquisition of the shares of the foreign entity. In case of a swap of shares, the indirect transfer tax provisions under the IT Act shall also have to be considered.

Other tax considerations pursuant to internalisation include concerns around tax assessment risk for foreign shareholders in India, non-applicability of any tax treaty benefits (that were previously available to foreign shareholders), lapse of any accumulated losses available to the Indian and offshore entities prior to internalization, tax implications in the hands of foreign shareholders at the time of exit from the Indian entity.

Foreign Exchange Compliance

In-bound mergers in compliance with the Foreign Exchange Management (Cross Border Merger) Regulations, 2018 shall be deemed approved by RBI. If not compliant, cross-border merger transactions shall require prior RBI approval.

Further, issuance or transfer of securities to non-residents through in-bound mergers must adhere to regulatory guidelines, entry routes, sectoral caps, and reporting requirements as set out under the applicable foreign exchange laws.

Feasibility Of IPOs

An exit within a definitive timeline is key for institutional investors. While IPOs remain a preferred mode of exit, the overall market sentiment and reaction towards a to-be listed company's products / services and sector at the time of a contemplated exit cannot be predicted. Furthermore, existing investors will also have to consider the transfer restrictions prescribed by SEBI on the shares held by them.

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Given that a reverse flip may entail the entry of foreign investors in India, it may require prior approvals from the Government of India

shareholders in advance.

Other Regulatory Approvals

Numerous other regulatory and sectoral approvals (depending upon the sector that the entity is operating in) may be triggered, not only in India but also in the host countries of the offshore entity. Further, requirement of an approval of the Competition Commission of India may need to be assessed.

In Conclusion

The attractiveness of valuations in the Indian market, coupled with the economic benefits for India, is driving the trend of reverse flipping in India. However, operational presence and shareholders spread across multiple jurisdictions leads to a variety of interconnected factors that will have to be collectively assessed and aligned while analyzing the feasibility of internalisation, so as to ensure that the results outweigh the considerations and hurdles for its consummation.

Startup Ecosystem

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