Reverse Flip – A Recent Trend!

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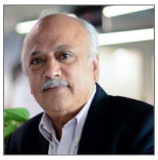

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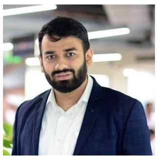

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I. Background[1]

Back in the day, from the early 2000s to a few years back, Indian business houses primarily looked to the West for a potential stock market listing. NASDAQ was the favoured destination for new-age businesses, as it offered a wider pool of investors and better valuations. Consequently, most start-ups and private equity-led businesses externalised or flipped their structures.

Flipping means the process of transferring the ownership of the Indian entity to a foreign entity.

In simple terms, even as the business carried on its operations in India, the business would be owned by a foreign company. The flip will result in the Indian entity becoming a wholly owned subsidiary of a foreign company, even as business operations continue in

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This externalised structure was adopted by multiple new-age businesses in the e-commerce, fintech, and software space. Singapore, the USA, and UK are some popular jurisdictions in which Indian entities have 'flipped.'

Reverse Flipping means the process of transferring the ownership of the foreign entity to Indian entity.

However, a recent trend has seen a reversal, with entities that previously flipped their structures now seeking to "flip back" to India. In other words, if the value was previously held by an entity incorporated outside India, it must now be held by an entity incorporated in India.

The reverse flip will essentially involve swapping of shares of the foreign entity held by Indian and foreign shareholders with shares of the Indian entity, pursuant to which the foreign entity may be liquidated or merged with the Indian entity, and all shareholders at the offshore level hold shares of the Indian entity.

A. Why Reverse Flip

Post-COVID, Indian capital markets have experienced significant value appreciation, attracting key financial institutions and Foreign Institutional Investors (FIIs). Coupled with the growing interest of domestic mutual funds and retail investors, the Indian markets are currently offering better valuations for new-age businesses compared to Western markets. Given this trend, the Indian market presents an attractive opportunity for promoters and private equity investors to consider a near-term exit through an initial public offering. Based on various media reports available, we understand that few established companies like Phone pe[2] ,Groww[3], Razorpay[4], Pine Labs[5] are either are in the process of internalisation in India, which demonstrate the popularity of the reverse flip.

While the commercial rationale for the reverse flip is clear, the process is not simple, and it involves several tax and regulatory issues.

B. Structuring options

The most popular options for reverse flipping are an inbound merger (i.e., a foreign entity merging with an Indian company) or a swap of shares, where the offshore shareholder swaps their holding in the foreign entity for shares in the Indian entity.

In this article, we have proceeded with the understanding that the foreign entity to be flipped in India is currently based in the USA. Accordingly, we will analyze the tax and regulatory implications that may arise in both India and the USA when flipping the structure from the USA to India.[6].

The below table provides a bird's eye view of the tax and regulatory implications in India and the USA on various structuring options:

Structuring Option	India Tax Implications	US Tax Implications	Regulatory Requirements
Inbound Merger (US Corp with Indian Corp)	Tax-neutral if the merger complies with Section 2(1B) of the Income Tax Act, 1961. No tax implications for the merging entity or the shareholders of the merging entity.	May not qualify as tax-free IRC Section 368 merger. Capital gains may arise as if US Corporation transferred assets (including stock of Indian Corporation) at FMV.	Requires compliance of Rule 25A of Companies (Compromise, Arrangement and Amalgamation) Rules, 2017 and Foreign Exchange Management (Cross Border Merger) Regulations 2018. No prior RBI approval required for in bound

Structuring Option	India Tax Implications	US Tax Implications	Regulatory Requirements
			mergers in compliance with Cross border merger regulations
Swap of Shares	Potential capital gains tax for shareholders under indirect transfer provisions of the Indian Income Tax Act. Tax treaty benefits may need evaluation.	Deemed dividend and capital gain implications for the US entity and investors. If certain conditions are met, transaction could be achieved in a tax free manner. Availability of Credit for taxes paid in India under Indirect transfer rules remain an issue.	Permitted under automatic route so long it complies with the conditions stipulated under FEMA Rules and Regulations. Reporting in Form FC for ODI and Form FC-GPR / FC – TRS for FDI regulations.
Slump Sale followed by liquidation	No tax implication on offshore slump sale. Receipt-based taxation on liquidation of US Corp for Indian shareholders.	Capital gains for US Corp on business transfer (including transfer of shares of Indian Corporation to the shareholders). Potential capital gains for US shareholders on liquidation of US Corp.	No regulatory approvals for slump sale. Change in shareholding on liquidation will have to be reported to the AD banker.

Detailed implications of the various structuring options:

I. Merger of US Corporation with Indian Corporation

The Indian Companies Act, 2013, permits an inbound merger of a foreign company with an Indian Company[7].

In India, the scheme of merger and amalgamation is a court-driven process requiring approval from the National Company Law Tribunal ('NCLT') for implementation, making it a time-consuming process. The parties to the merger are required to file a 'scheme of merger' with the NCLT stating all relevant facts and objectives of the merger.

Majority of the creditors and shareholders of both merging entities must approve the scheme of merger. Also, the scheme of the merger will be approved by NCLT only after requisite sanctions have been provided by regulatory authorities like the Income Tax Office, Registrar of Companies, Reserve Bank of India ('RBI')[8], Securities and Exchange Board of India[9], Etc.

India Tax Implications

An inbound merger done in compliance with the provisions of the Income Tax Act, 1961 ('Act')[10] is regarded as a tax-neutral merger and will not have any tax implications for the transferor entity, transferee entity, or the shareholders of the transferor entity.

Accordingly, if the merger qualifies as a tax-neutral merger, there would be no capital gains tax implications on the merging USA entity as the Act specifically provides that any transfer of capital asset in a tax-neutral merger would not be regarded as a transfer[11]. Also, transfer of shares of the merging entity by the shareholders will not attract any capital gains tax so long as the shareholders of the merging entity receive shares of the merged entity in consideration for the transfer and the resulting merged entity is an Indian Company.[12]

However, if the inbound merger fails to satisfy any of the prescribed tax neutrality conditions, it will amount to extinguishment or cancellation of shares of the Indian entity by the USA entity, which will be taxable as capital gains income of the USA entity.

Also, the Act explicitly provides that gift tax provisions will not be attracted when shares of a merging company are transferred by the shareholders pursuant to a tax-neutral merger[13].

Tax treaty benefits available to foreign shareholders when they hold shares of the USA entity will need a relook post-merger, as they will now be holding shares of the Indian entity. Accordingly, the Double Taxation Avoidance Agreement ("DTAA") between India and the jurisdiction of which the foreign shareholder is a resident will need to be evaluated for availing of DTAA benefits.

India Regulatory Compliances

Two rules govern inbound mergers: Rule 25A of the Companies (Compromise, Arrangement and Amalgamation) Rules 2017 and the Foreign Exchange Management Cross Border Merger Regulations, 2018, as framed by the RBI.

As per Rule 25A, inserted in April 2017, an inbound merger of a foreign company with an Indian company requires prior approval from the RBI prior to filing an application with the NCLT.

Subsequently, in March 2018, RBI issued Cross Border Merger Regulations to govern mergers between a foreign and Indian entities. As per the said regulation, the merging entities are mandated to comply with all the conditions framed by the RBI in the cross-border regulations. RBI approval is deemed for entities fulfilling all requirements. A specific RBI approval is required only when merging entities are unable to comply with prescribed conditions.

As per Cross Border Regulations, the resultant Indian company is permitted to issue or transfer any security to a person resident outside India subject to compliance with pricing guidelines, entry routes, sectoral caps, attendant conditions, and reporting requirements for foreign investment as laid down under Foreign Exchange Management (Non-debt Instruments) Rules, 2019, along with provisions of the recently enacted Foreign Exchange Management (Overseas Investment) Regulations, 2022.

Additionally, the Cross Border regulations require that[14]:

1. All guarantees or outstanding borrowings of the foreign company from foreign sources which become the borrowings of the Indian entity must, within a period of two years, comply with External Commercial Borrowing norms, Trade Credit norms, or other foreign borrowing norms (as applicable). Also, no remittance for repayment of such liability can be made from India within a period of two years.
2. The resultant Indian entity can acquire or hold any asset or securities outside India that an Indian entity is permitted to hold or acquire under the Foreign Exchange Management Act, 1999 ("FEMA"), rules or regulations framed thereunder. In case the resultant Indian entity is holding any asset that is barred, such asset must be sold within a period of two years from the date of sanction of the scheme, and the sale proceeds must be repatriated outside India immediately through banking channels.
3. The valuation of the Indian entity and the foreign company must be done in accordance with Rule 25A of the Companies (Compromise, Arrangement and Amalgamation) Rule, 2016

Any cross-border merger undertaken in accordance with the Cross Border Regulations shall be deemed to have the RBI's prior approval as required under Rule 25A of the Companies (Compromise, Arrangement and Amalgamation) Rule, 2016.

Also, a certificate from the Managing Director and Company Secretaries of both entities ensuring compliance with the Cross Border Regulations must be filed along with the application filed with the NCLT.[15]

US Tax Implications

IRC Sections 367 and 368 and related regulations govern the federal tax implications of outbound mergers (from a US perspective).

The merger may not qualify as a tax-free merger under IRC section 368 as it is an outbound merger whereby assets of a US Corporation are construed as being transferred to an Indian Corporation. In the case of outbound transfer, IRC section 367 overrides the tax-free treatment, and such a transaction becomes taxable in the hands of a US Corporation. Capital gain implications may arise in the hands of the US corporation if the US corporation sold the shares of the Indian corporation and other business assets were sold at a fair market value.

No tax incidence may get triggered in the hands of shareholders if the conditions of a tax-free merger under IRC Section 368 conditions are met. General conditions under IRC Section 368 are as follows:

- Transfer of all/substantially all of the assets
- Continuity of ownership interest in the target corporation
- Continuity of business of the target corporation
- Re-organization being done for a business purpose
- Solvency Conditions

USA Corporate Law Provisions

In addition to compliance with Indian legislation, an outbound merger may necessitate a detailed analysis in accordance with US corporate law. Generally, the procedural timeline for completing a merger under US corporate law is significantly less compared to the process prescribed by Indian regulations. Notably, the USA does not require any court approval for merger but the corporate laws of the incorporation state of the US entity needs careful consideration.

II. Swap of shares

India Tax Implications

According to the Act, shares of a company incorporated outside India will be deemed to be situated in India if the shares derive, directly or indirectly, their value substantially from assets located in India. Transfer of shares of such a foreign company will result in an indirect transfer of shares of an Indian company taxable in India[16].

Accordingly, in case of a reverse flip by way of a swap of shares, the indirect transfer tax provisions must be evaluated from the perspective of extinguishment of shares of the shareholders of the foreign company.

In case the reverse flip attracts indirect transfer provisions, there may be a capital gains tax exposure under the Act[17] for the foreign shareholders. For calculating capital gains tax, the foreign shareholders will first have to calculate the delta between the value of the shares of the USA entity at the time of such reverse flip and the cost of acquiring the shares of the USA entity. Such delta will then be apportioned based on the ratio of fair market value of assets located in India (ie Indian entity) with the fair market value of all assets of the company (ie USA entity).

India Regulatory Requirement

The swap of shares between a resident and a non-resident entity is permissible under the automatic route[18] subject to adherence of pricing guidelines, entry routes, sectoral caps and attendant conditions for foreign investment as laid down under FEMA regulations.

Also, reporting will be required in in Form FC (for direct investment by an Indian company in a company residing outside India) under the ODI regulations and under the FDI regulations in Foreign Currency – Gross provisional return ('FC-GPR') / FC- TRC for direct investment in an Indian company by a company residing outside India.

US Tax Implications

From a federal income tax perspective, the swap of shares transaction effectively may be bifurcated into two steps as follows:

Step 1: The US Corporation distributes the shares of the Indian Corporation to shareholders

Step 2: Shareholders of the US Corporation transfer the shares of the US Corporation to the Indian Corporation in exchange for shares of the Indian Corporation.

For Step 1, IRC section 355 needs to be evaluated. The conditions for a spin-off under IRC Section 355 are as follows:

- Control Requirement
- Trade or Business Requirement
- Distribution Requirement
- Device Requirement
- Business Purpose Requirement
- Continuity Requirement

If all the above conditions are satisfied, then accordingly, the deemed distribution of stock of the Indian Corporation by the US Corporation to its shareholders may qualify for a tax-free treatment under IRC section 355. The benefit of IRC section 355 may be available only to the extent the shareholders are US tax residents.

For Step 2, under IRC Section 351(a), no gain or loss is recognized when the property is exchanged solely for stock in a US corporation, provided the transferors control the corporation (owning at least 80% of voting power and total stock). However, if US shareholders transfer property to a foreign corporation, Section 367(a)(1) disallows Section 351 treatment, meaning capital gains may be triggered. Thus, capital gains implications may arise in the hands of the US shareholders as if they sold the shares of the US corporation at a fair market value.

III. Slump Sale and liquidation

While less common, another way to flip the structure is to slump sale of the US business followed by liquidation of the existing US corporation.

This option can be undertaken by means of the following steps:

Step 1: Indian Corporation forms a new wholly owned subsidiary in the US.

Step 2: The existing US Corporation transfers its business to the new US subsidiary for cash consideration.

Step 3: The existing US Corporation is liquidated

India Tax Implications

In this case, business transfer by way of slump sale happens from one USA entity to another USA entity outside India. As the transaction is an offshore transaction executed between two non-residents, it will not have any tax or regulatory implications in India.

On liquidation of the existing US Corporation, shareholders of the existing US Corporation will receive shares of the Indian company. As the situs of shares of the Indian company is in India, even if the transfer of ownership is accompanied outside India, there will be receipt-based taxation in India for shareholders[19] on liquidation of existing US Corporations.

As per the provisions of the Act[20] the shareholders will be liable to deemed dividend taxation[21] to the extent of accumulated profits of existing US Corporation as on the date of liquidation. Any amount received by the shareholders over and above accumulated profits of existing US Corporation will be taxed as capital gains post reduction of the amount invested by shareholders in the shares of existing US Corporation.

Depending on their residential status, the shareholders will be entitled to benefits under the applicable tax treaties if the provisions of the treaty are beneficial compared to the Act.

US Tax Implications

Slump sale will trigger tax incidence in the hands of the US Corporation.

The transfer of the US Corporation's local business to a new subsidiary may be construed as transfer and accordingly result in capital gains for the US Corporation. The gain may be calculated as the difference between the sale consideration (must be equal to the fair market value of the assets transferred) and the tax basis of assets transferred to the new subsidiary.

The liquidation of a US Corporation may have tax implications for both the corporation and its US shareholders. Specifically, the US Corporation may generate capital gain income as if it had sold its shares in the Indian subsidiary at fair market value. Furthermore, US tax resident shareholders may also generate capital gain income as if they had sold their shares in the US Corporation for an amount equivalent to the fair market value of the liquidation proceeds received. Availability of foreign tax credit for tax paid in India may still remain an issue. Under the domestic rules of USA (DTAA also gives right to USA), gain generated on sale of shares of any corporation may be sourced to the residence of seller and accordingly foreign tax credit may not be available for US residents, gain being a US source income.

C. Anti-Inversion Gain Rules – US Tax Implications:

Anti-Inversion gain may need to be evaluated in the case of all contemplated structuring options. Following is the overview of the rules:

Inversions were in vogue in the late 1990s until Congress passed the American Jobs Creation Act of 2004, adding section 7874 to the Internal Revenue Code. In 2004, IRC Section 7874 was enacted to address corporate inversions. This section contains provisions designed to reduce the incentives for US multinational companies to engage in inversions and move out of US taxing jurisdiction.

Prior to the introduction of IRC Section 7874, the primary tax cost of a corporate inversion fell on the shareholders of the inverting US parent corporation, who faced a potential "toll charge" under IRC Section 367(a). However, corporate inversions were often carried out when shareholders had minimal built-in gains in the stock of the US parent or cases involving foreign or tax-exempt shareholders, potentially no US tax liability at all. This reduced the toll charge's effectiveness as a deterrent. Consequently, even though the US parent might have incurred taxable income under IRC Section 367(b) (such as from de-controlling its CFCs), the tax costs at both the US parent and shareholder levels were frequently outweighed by the anticipated future US tax savings and thus did not prevent inversions.

IRC Section 7874 applies to certain inversions involving a domestic corporation (DC) or a domestic partnership (P/S) where a new foreign parent corporation is classified as a "surrogate foreign corporation" (SFC).

For a foreign corporation (FC) to be considered an SFC, three tests must be satisfied:

1. Acquisition test, i.e., FC directly or indirectly acquires substantially all of the properties held by a DC,
2. Ownership test, i.e., at least 60% of the stock (vote or value) of FC is held by former Shareholders of DC “by reason of” holding stock in DC, and
3. SBA test: The “Expanded Affiliated Group” (EAG) that includes the acquiring FC does not have substantial business activities (SBA) in the foreign country in which the acquiring FC was created or organized compared to the EAG’s worldwide (WW) activities.

The tax consequences under IRC 7874 depend on meeting the ownership test, which requires a specific percentage of the FC's ownership to be held by the former shareholders or partners of the domestic target "by reason of" their previous ownership in the domestic target.

Inversions governed by IRC 7874 are often referred to as "80% inversions" and "60% inversions," based on the ownership percentage. Therefore, determining this ownership threshold is crucial for establishing whether IRC 7874 applies to the transaction.

In an 80% inversion, the new foreign parent is classified as a domestic corporation (DC) for all IRC purposes. As a result, IRC 367(a) does not apply to the shareholders of the domestic target since there is no outbound transfer of property for US tax purposes, and thus, no outbound "toll charge" is imposed on the shareholders.

Conversely, in a 60% inversion, the new foreign parent is recognized as a foreign corporation for US tax purposes. However, the taxable income of an expatriated entity must at least equal its "inversion gain" recognized over the 10-year applicable period. IRC 7874 effectively restricts the ability of expatriated entities to use net operating losses (NOLs) or other tax attributes to reduce US tax on their inversion gain.

Under Inversion Rules, a foreign corporation will be treated as a surrogate foreign corporation if, after the acquisition, the expanded affiliated group (EAG) that includes the foreign corporation does not have substantial business activities in the foreign country where the foreign corporation is created or organized, compared to the total business activities of the EAG. This means that if the EAG has substantial business activities in the foreign country, the foreign corporation may not be treated as a surrogate foreign corporation. Certain parameters need to be evaluated for EAG, which include criteria for the employee, their compensation, tangible assets deployment, and revenue operations.

D. Other tax considerations

Assessing limitation of loss utilization under IRC section 382

If there are carryover losses available for the US corporation and which can be offset against the exit tax at entity level, it is important to assess if the losses are freely available for utilization. If there have ownership changes (More than 50% change over a 3 year testing period) in any of prior years(with losses available) then such loss generated as of the date of such ownership change will be subject to restriction on future utilization. Such limitation is computed under IRC section 382 at federal and state level.

Qualified small business stock Capital gain Exclusion

In case, there are any capital gain at US shareholder level, then such gain may be exempt from taxation subject to certain thresholds and condition prescribed under IRC section 1202. Shareholders may need t0 carefully assess this provision to be able to avail the benefit of this provision.

E. Concluding remarks:

While corporate groups are considering a reverse flip to capitalize on Indian market valuations—and there have been calls to simplify the transition—the government has maintained that while corporates are welcome to benefit from listing opportunities in India, the process must comply with existing laws and regulations. Currently, no special provisions exist for such migration of value.

As startups and new-age businesses recognize the valuation benefits, it is essential to collectively assess regulatory compliance and the presence of shareholders across multiple jurisdictions when evaluating the feasibility of a reverse flip, ensuring that the advantages outweigh the challenges involved in completing the process.

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1 The authors would like to acknowledge Mihir Desai, Director, India Tax and Prathamesh Hegishte, Director, US Tax as co-contributors, whose collaborative spirit made this work possible.

[2] https://economictimes.indiatimes.com/tech/technology/phonepe-shifts-headquarters-from-singapore-to-india/articleshow/94621544.cms

[3] https://economictimes.indiatimes.com/tech/startups/groww-moves-domicile-to-india-from-the-us/articleshow/109986924.cms?from=mdr

[4]https://www.moneycontrol.com/banking/razorpay-likely-to-go-public-in-fy28-aims-to-complete-reverse-

flipping-by-fy25-says-co-founder-article-12811702.html#google_vignette

[5] https://www.medianama.com/2024/05/223-pinelabs-gets-approval-singapore-court-reverse-flip-india/

[6] Our comments are restricted to the provision of Indian Income Tax Act, 1961, Foreign Exchange Act, 1999 and rules and regulations thereof, including the Foreign Exchange Management (Cross Border Merger) Regulations, 2018.

[7] Section 234 of the Companies Act,2013

[8] Only for Cross Border Merger

[9] For Mergers involving a listed entity

[10] Section 2(1B) of the Act

[11] Section 47(vi) of the Act

[12] Section 47(vii) of the Act

[13] Section 56(2)(x) of the Act

[14] Regulations 4(3), 4(4),4(5), 4(6)(1) of the Foreign Exchange Management (Cross Border) Regulations, 2018

[15] Regulation 9(1) and (2) of the Foreign Exchange Management (Cross Border) Regulations, 2018.

[16] Explanation 5 to Section 9(1)(i) of the Act

[17] Subject to small shareholder and DTAA benefits

[18] FEMA non-debt regulation, 2019 read with FEMA non-debt regulation, 2019 and FEMA (Overseas Investment) Rules, 2022.

[19] Sections 5 read with Section 46(2) of the Act

[20] Section 46(2) of the Act

[21] Section 2(22)(c) of the Act