Externalisation Of Holding Structure

A Trend in Vogue for Startups

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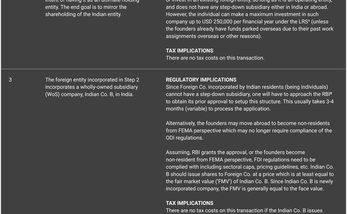
FOUR PART SERIES

In **Part One** of this series on Externalisation, *we explored the basics of externalisation*, the commercial considerations providing an impetus to the decision and the extant tax and regulatory aspects governing externalisation.

Part Two of this series covered here delves further. Here, *we discuss the different methods in which you can externalise your holding structure along with the plausible tax and regulatory implications from India perspective.* As you read this piece, you would realize that there are different ways, and they can be further tailored to suit each entity's individual requirements.

1 Ways to Externalise and its Tax & Regulatory Implications?

a. Business transfer



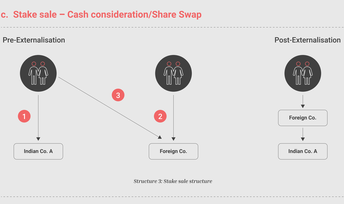
Structure 1: Business transfer

The above diagram has been depicted through step-wise action and their implications in the below table:

STEP NO.	ACTION	TAX AND REGULATORY IMPLICATIONS
1	Typically, the starting point is to incorporate a start-up entity (usually a company) in India. At this stage, the founders are just getting started and may not have thought about the holding structure, which usually gains significance when the foreign investors show some interest.	There are no tax or regulatory implications at this stage as such since a new entity is being incorporated in India and the fact that the founders are Indian residents.
2	An entity is incorporated outside India by the founders of the Indian Co. A with the intent of having it as an ultimate holding entity. The end goal is to mirror the shareholding of the Indian entity.	**REGULATORY IMPLICATIONS** An Indian resident (individual) is permitted to setup a new foreign entity, or invest in an existing foreign entity, so long as it is an operating entity; and does not have any step-down subsidiary either in India or abroad. However, the individual can make a maximum investment in such company up to USD 250,000 per financial year under the LRS[1] (unless the founders already have funds parked overseas due to their past work assignments overseas or other reasons). **TAX IMPLICATIONS** There are no tax costs on this transaction.
3	The foreign entity incorporated in Step 2 incorporates a wholly-owned subsidiary (WoS) company, Indian Co. B, in India.	**REGULATORY IMPLICATIONS** Since Foreign Co. incorporated by Indian residents (being individuals) cannot have a step-down subsidiary, one will have to approach the RBI[2] to obtain its prior approval to setup this structure. This usually takes 3-4 months (variable) to process the application. Alternatively, the founders may move abroad to become non-residents from FEMA perspective which may no longer require compliance of the ODI regulations. Assuming, RBI grants the approval, or the founders become non-resident from FEMA perspective, FDI regulations need to be complied with including sectoral caps, pricing guidelines, etc. Indian Co. B should issue shares to Foreign Co. at a price which is at least equal to the fair market value ('FMV') of Indian Co. B. Since Indian Co. B is newly incorporated company, the FMV is generally equal to the face value. **TAX IMPLICATIONS** There are no tax costs on this transaction if the Indian Co. B issues shares to the Foreign Co. at a price which is at least equal to the fair market value ('FMV') of Indian Co. B. Since Indian Co. B is newly incorporated company, the FMV is generally equal to the face value. Furthermore, such infusion of capital by Foreign Co. will be required to be reported under transfer pricing regulations.
4	The WoS, Indian Co. B, assumes the business of the start-up, Indian Co. A, through a Business Transfer Agreement and becomes the operating company.	**REGULATORY IMPLICATIONS** There are no implications of foreign exchange regulations for this transaction. Furthermore, there are no restrictions under the Corporate Law for this transaction. **TAX IMPLICATIONS** Business transfer can take place as a whole on a slump sale basis. Any undertaking which is more than 36 months old is liable to tax as long-term capital gains and up to 36 months is liable to tax as short-term capital gain. To determine the capital gains, the FMV of the specific assets transferred shall be considered as the sale consideration of the undertaking. The net worth of such division/undertaking/entity shall be deemed to be the cost of acquisition. Since it is a startup entity, we have not considered itemized sale of assets assuming there will be no need to continue any business in the transferor entity (Indian Co. A). Furthermore, transfer pricing compliance shall also be required to be made since such transaction between Indian Co. A and Indian Co. B may fall under deemed international transaction under the transfer pricing regulations.
5	Winding up of Indian Co. A	**REGULATORY IMPLICATIONS** Subsequent to the business transfer, Indian Co. A may be wound up. **TAX IMPLICATIONS** There are no tax costs at this stage.

[1] *Liberalised Remittance Scheme*
[2] *Reserve Bank of India*

b. Merger / amalgamation

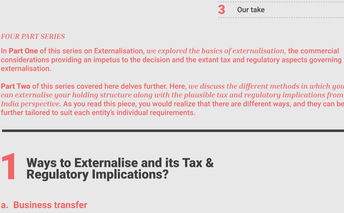


Structure 2: Merger / amalgamation

The above diagram has been depicted through step-wise action and their implications in the below table:

STEP NO.	ACTION	TAX AND REGULATORY IMPLICATIONS
1, 2, 3	Same as in Structure 1 (Business Transfer)	Same as in Structure 1 (Business Transfer)
4	**DOMESTIC MERGER** Indian Co. A is merged/amalgamated into Indian Co. B.	**REGULATORY IMPLICATIONS** There are no implications of foreign exchange regulations on this transaction. *However, one will have to take prior approval of the Regional Directorate or National Company Law Tribunal ('NCLT') for the merger/amalgamation. This usually takes 4-6 months (variable).* **TAX IMPLICATIONS** Subject to conditions, amalgamation/merger between two Indian entities is tax neutral for the transferor entity and its shareholders. There are no tax implications on the transferee entity as well.
	CROSS-BORDER MERGER Alternatively, depending on the nature of business of the start-up, Indian Co. A may be directly merged with the Foreign Co., in which case, Indian Co. B will not be required at all.	***CROSS-BORDER MERGER*** **REGULATORY IMPLICATIONS** Indian company can permits cross-border merger subject to fulfillment of the prescribed conditions. Prior approval of NCLT will be required for the merger/amalgamation. This usually takes 4-6 months (variable). Indian resident founders can hold securities of Foreign Co. allotted on the merger of Indian Co. A with Foreign Co. However, ODI regulations (read with LRS) will have to be complied with. Therefore, each individual can hold securities in the Foreign Co. up to the prescribed limit of USD 250,000 per year. Post-merger, any office of the Indian Co. A in India shall be deemed to be the branch office of Foreign Co. Hence, it shall have to comply with Indian foreign exchange regulations applicable on branch offices of foreign companies in India. One should keep in mind the fact that a branch office cannot carry out manufacturing activities. Valuation requirements under ODI regulations, Companies Act, 2013 and Income Tax Act, 1961 may be complied with. **TAX IMPLICATIONS** Currently, inbound mergers are tax neutral and not outbound mergers. Capital gains tax is applicable on the transferor entity (Indian Co. A) as well as on its shareholders. Foreign transferee entity (Foreign Co.) will be required to obtain permanent account number ('PAN'), Tax Deduction Account Number ('TAN') and undertake other relevant statutory and regulatory compliances in India. Both entities will be required to comply with transfer pricing regulations. Branch office of Foreign Co. will have to manage the permanent establishment risk in India.

c. Stake sale – Cash consideration/Share Swap



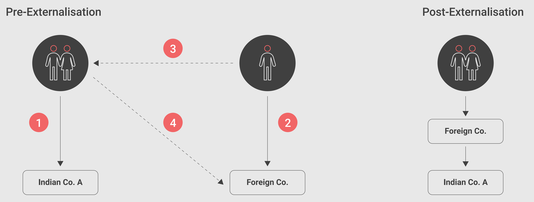
Structure 3: Stake sale structure

The above diagram has been depicted through step-wise action and their implications in the below table:

STEP NO.	ACTION	TAX AND REGULATORY IMPLICATIONS
1, 2	Same as in Step 1, 2 under Structure 1 (Business Transfer)	Same as in Step 1, 2 under Structure 1 (Business Transfer)
3	Foreign Co. acquires shares of Indian Co. A from its founders and the Indian company becomes a WoS of the foreign company. In consideration, the Indian founders may be paid lump sum in cash or may be allotted shares in Foreign Co. or a combination of both.	**REGULATORY IMPLICATIONS** Settlement of the transaction via cash settlement is permissible. Settlement via share swap [where resident individuals hold shares in a foreign entity (Foreign Co., in this case) which has a step-down subsidiary (Indian Co. B, in this case)] is not permissible under the automatic route. Furthermore, this structure will also lead to round tripping. Hence, prior RBI approval will be required in this case. For a cash-settled transaction and share swap transaction with RBI approval, the Indian founders must comply with FDI guidelines while selling their stake in Indian Co. A to a non-resident. The selling price should be at least equal to the FMV of such shares. **TAX IMPLICATIONS** Foreign company should acquire shares from the Indian founders at NAV or more (as on the transaction date). Anything less than that will attract tax on the shortfall, if such shortfall exceeds INR 50,000. On the other hand, founders will be liable to pay capital gains tax on the same at the applicable rates based on the period of holding (long-term or short-term[#]. Such transfer should not be made at less than NAV, as in that case NAV shall be deemed to be the sales consideration and capital gains shall be computed accordingly.

[#] *Period of holding up to 24 months, in case of unlisted shares, is considered to be short-term and anything beyond 24 months is considered to be long-term.*

d. Gift Structure

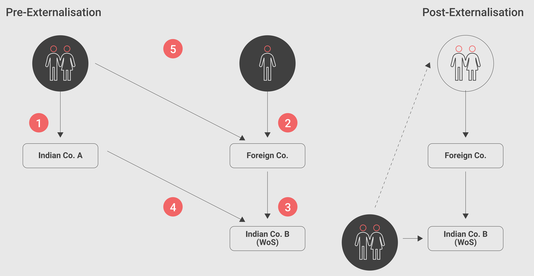


Structure 4: Gift structure

The above diagram has been depicted through step-wise action and their implications in the below table:

STEP NO.	ACTION	TAX AND REGULATORY IMPLICATIONS
1	Same as in Step 1 under Structure 1 (Business Transfer)	Same as in Step 1 under Structure 1 (Business Transfer)
2	A foreign investor (independent third party) sets up a foreign company	**REGULATORY IMPLICATIONS** No implications at this stage since the Indian founders are not involved at this stage. **TAX IMPLICATIONS** No tax implications from the Indian perspective.
3	Foreign Co. acquires shares of Indian Co. A from its founders and the Indian company becomes a WoS of Foreign Co. Founders may be paid in cash. This structure is possible only when the foreign investor believes in the business of the Indian Co. A and is desirous of coming on its board along with the founders.	**REGULATORY IMPLICATIONS** Such transaction should take place at FMV or more of the equity shares. Obtain valuation certificate and also comply with other conditions including sectoral caps prescribed under the FDI guidelines. **TAX IMPLICATIONS** Same as in Step 3 of Structure 3.
4	The foreign investor may gift the shares of Foreign Co. to the Indian founders.	**REGULATORY IMPLICATIONS** An Indian resident can receive shares as a gift from a non-resident. No separate approval is required for the same. However, once the gift transaction is complete, the resultant structure will result into Indian resident(s) owning a foreign company which holds the shares of an Indian company. In this structure, even though there is no outflow of funds from India, since Indian founders have only received the shares of the foreign company as a gift, it may still fall under the round tripping restriction. The ODI regulations are silent on this type of structure, but it is advised to obtain prior approval from RBI before implementing this structure. This structure may not work if the draft ODI regulations released for public comments on 9 August 2021 are finalized in the same form and shape since that restricts receipt of gifts only from relatives (as defined under the Companies Law) of an individual. **TAX IMPLICATIONS** Founders receiving the shares will have to pay tax in case the value of underlying shares exceeds INR 50,000. The taxable value of such shares shall deemed to be the NAV of such company. However, no tax shall be payable if such shares are received as a gift from founders' relatives as defined under the tax law.

e. Shadow Structure



Structure 5: Shadow structure

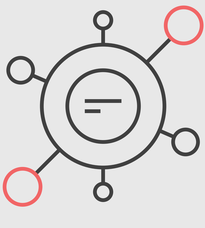
The above diagram has been depicted through step-wise action and their implications in the below table:

STEP NO.	ACTION	TAX AND REGULATORY IMPLICATIONS
1	Same as in Step 1 under Structure 1 (Business Transfer)	Same as in Step 1 under Structure 1 (Business Transfer)
2	Setting up of a foreign company by a third-party foreign investor or by the Indian founders.	**REGULATORY IMPLICATIONS** No implications at this stage if a non-resident incorporates a foreign company. However, if the Indian resident founders incorporate a foreign company, prior RBI approval and compliance with ODI guidelines (read with LRS) will be required. **TAX IMPLICATIONS** No tax implications from Indian perspective.
3	The foreign entity incorporated in Step 2 incorporates a wholly-owned subsidiary (WoS) company, Indian Co. B, in India.	Same as in Step 3 under Structure 1 (Business Transfer)
4	Indian Co. A is merged/amalgamated into Indian Co. B in return of shares of Indian Co. B.	Same as in Step 4 of Structure 2 (Merger / Amalgamation)
5	Original investors of Indian Co. A which now hold shares of Indian Co. B shall enter into a put option agreement with the Foreign Co. By virtue of the put option agreement, investor in Indian Co. B have the right to exit when Exit event occurs in Hold Co (like listing on stock exchange, etc.) as if the investments were directly made in the Foreign Co. In short, all rights and obligations of investors in Indian Co. B will get mirrored in the Foreign Co.	**REGULATORY IMPLICATIONS** No approvals required since this is a contractual transaction.

2 When to Externalise?

Timing of externalization is a very crucial point to decide. It is generally better to externalise in the initial stages, to avoid substantial tax costs. Once the fund-raising picks up pace, FMV of assets being transferred (shares/other assets) usually increase and consequently the business valuation. Having said that, flipping the structure in the initial stages would be challenging due to numerous regulatory/compliance hassles.

While multiple options are available to externalize a structure as discussed above, the key lies in timing the externalization right post factoring some red flags.



3 Our Take

Externalization of a structure is not a one-size-fits-all approach and need not necessarily be a move in the right direction for all start-ups.

The business model of certain start-ups and their growth strategies may necessitate a flip in structure and the benefits may outweigh the complexities and the costs of such externalization. On the other side, the ethos of certain businesses, their positioning in the market, their access to funding and personal aspirations of the founders may not require an externalization.

Also, the recent development directed towards permitting the Indian companies to list on foreign stock exchanges is a welcome measure and would provide better access to global capital without the need of having an overseas entity.

At the end of the day, a business structure would need to necessarily facilitate growth of the business and can never been impediment. It is, therefore, important to have a bespoke structure that would be the right fit for each organization.

More in this series

In this piece of knowledge, we observe that externalization can be achieved in different ways. It is always advisable to be guided by experts in the field who can help you navigate through the maze of externalisation process.

Part Three of this series will specifically focus on Special Purpose Acquisition Company (SPAC) or blank cheque companies and the regulations applicable to them.
The Indian founders have welcomed the externalisation structures as evident from the number of deals in this space. This has pushed the regulators to come out with regulations paving way for smooth execution of externalisation.

Part Four enlists some regulatory changes in the pipeline which are sure to see the light of the day in the near future.