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RE-DOMICILE THE START-UPS TO IFSC

(Looking into the suggestions of IFSCA Committee)

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India is amongst the largest startup ecosystem in the world, yet a worrying trend of Indian startups 'externalizing' or 'flipping' to overseas jurisdiction has come to the fore, which refers to a process where, the entire ownership of an Indian startup entity is transferred to an overseas entity, accompanied by transfer of all Intellectual Property and data. This effectively transforms an Indian startup entity into a 100% subsidiary of a foreign entity, with the founders/investors retaining same level of ownership in Indian startup albeit indirectly via the foreign holding entity. Such externalization amongst many other adverse consequences results in tax revenue loss and leads to brain drain of entrepreneurial talent leading to stalling of innovation in the country. It also negatively impacts India's digital diplomacy efforts which has become crucial aspects of international relations.

Owing to these alarming concerns, the IFSCA[1] constituted an expert committee[2] ("**Committee**") to examine the entire gamut of issues that had led to such externalization of start-ups to overseas jurisdictions and make recommendations to reverse the situation via making IFSC[3] in GIFT City as the first destination of choice for such Indian startups to set up their holding company ("**Hold Co.**"). Thus, the suggestions of the Committee centers around reviewing and providing recommendation for aligning of the tax and regulatory laws within the IFSC with international best practices, thereby creating an environment that actively incentivizes and supports Hold Co. structures in IFSC.

This write-up attempts to summarize the key regulatory & other issues identified by the Committee and the recommendations made to address such issues.

1. **Related to capital raising**: Debt (by way of issuance of bonds or debentures) or equity (via initial public offering or private placement) are typically the limited means available for Indian company to raise capital. To enable Indian startups to have access to wider capital, the recommendations revolved around the following:

1.1. Simple Agreement for Future Equity (SAFE) Instruments: This instrument acts as an agreement between investor and a company that provides the investor the leeway to acquire equity in the company in future. SAFE is similar to a convertible note, but unlike convertible notes, SAFE is equity and not debt, and does not accrue interest or carry maturity dates. The returns on SAFE depend upon the performance of the company. A SAFE investor may receive shares in the future (which may be in the form of preferred shares) when an equity financing round happens, or when a liquidity event occurs or may get bought out by the company at its discretion. The Committee recommended that the Indian laws should be appropriately amended to enable issuance of SAFE instruments.

1.2. Special Purchase Acquisition Companies (SPACs): Conceptually, SPAC is a newly set-up entity with no business activity of its own, which raises capital via listing on the stock exchange for the sole purpose of acquiring an operating company at a later stage. The end objective is (i) to get the operating company listed without following the mainstream listing process, by merging it with SPAC; or (ii) to enable the operating company to benefit from trading value and public funds of SPAC, through a simpliciter acquisition of the operating company. While SPACs are quite prevalent in overseas jurisdictions, in India there is no special framework which allows for SPAC listing on Indian stock exchanges. This is attributable to a restrictive Indian regulatory regime which places various practical limitations on any such transaction. Read our previous article where the SPAC concept and regulatory bottlenecks have been discussed at length:
https://demosite.finlabsindia.org/demo/Luthr

[1] International Financial Services Centres Authority
[2] The Expert Committee was constituted on March 21, 2023, under the chairmanship of Shri G. Padmanabhan, former Executive Director, Reserve Bank of India, and the report of the Expert Committee's report was made publicly available on August 21, 2023.
[3] International Financial Services Centre

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The Committee recommended introducing enabling provisions to recognize SPACs under Indian laws and allow entrepreneurs to list a SPAC incorporated in India on domestic and global exchanges.

1.3. Variable Capital Company (VCC)[4]: A VCC is a body corporate that has a variable capital base. It issues and redeems shares on an on-going basis, and with every issue or redemption, the capital base of the VCC changes. A VCC may either be a stand-alone entity with a single pool of capital/investments or may be an umbrella entity with multiple pools of capital/investments, each partitioned from the other. The rights and interests of an investor, either as a shareholder or creditor, are limited to the assets and liabilities of the pool to which the money has been provided. The report recommends adopting a VCC like legal structure, to *inter alia* attract foreign investors to invest in such VCCs thereby increasing traction for the startups in India.

1.4. Direct listing on offshore exchanges: The Committee recognized the constraints of unlisted companies to tap international markets for raising capital, given that unlisted companies are not permitted to directly list on offshore exchanges, which in-turn impedes the growth ambitions of start-ups, as their access to wider global pools of capital is blocked. Taking cognizance of this, the Committee recommended that unlisted start-up companies should be allowed to set up a Hold Co. in GIFT city, and thereafter such Hold Co. should be allowed to directly list its equity on certain specified offshore stock exchanges. Further, listing on IFSC exchanges should remain available as an option for such start-ups, and not made mandatory.

1.5. Relaxation for listing of start-ups on IFSC Exchanges: The Committee recommended to relax the eligibility criteria as provided under IFSCA Listing Regulations[5], for listing of start-ups in IFSC. The key criteria being: (a) having operating revenue of at least 20 million in preceding financial year (FY); (b) average pre-tax profit of at least USD 1 million during preceding 3 (three) FYs; and (c) having completed of 3 (three) years from business commencement.

2. Regulatory relaxations:

2.1. Liberalized Remittance Scheme (LRS)**:** It is recommended that instead of keeping the LRS limit for investment purposes in IFSC at par with the other general activities (like medical treatment, studies abroad etc.), it should be grouped under a different head, and a higher investment limit than the current USD 250,000 per financial year should be prescribed for investment in IFSC.

2.2. Relaxing Overseas Investment (OI) framework**:** As per the present OI framework, a resident individual (RI) is permitted to make overseas direct investment (ODI) with controlling rights in an IFSC entity. However, such IFSC entity (i.e., entity in which RI has a controlling stake) cannot have subsidiaries/step down subsidiaries outside of IFSC. The Committee noted that owing to this restriction, the RI cannot invest in Indian start-ups that have flipped back to India and have set-up their Hold Co. in IFSC. Thus, the Committee recommended to amend the OI provisions to allow ODIs in IFSC entities which have Indian subsidiaries.

2.3. Offshore Merger: The flipping of offshore offices to India through merger ("**In-Bound Merger**") can be done in tax-neutral manner only if it is done through NCLT[6] process, which runs anywhere between 6 to 18 months.

[4] Earlier, in September 2020, the IFSCA set up an Expert Committee under the chairpersonship of Dr. K. P. Krishnan to examine the feasibility of the VCC in India, which submitted its report in May 2021. On consideration of the Krishnan Committee's report and in consultation with stakeholders, the IFSCA set up an Expert Committee under the chairpersonship of Dr. M.S. Sahoo to draft a legal framework for allowing the VCC structure to operate in IFSCs in India, which submitted its report in October 2022.

[5] International Financial Services Centres Authority (Issuance and Listing of Securities) Regulations, 2021.

[6] National Company Law Tribunal

Besides, the RBI approval is required for In-Bound merger if it is not in compliance with Foreign Exchange Management (Cross Border Merger) Regulations, 2018. In view of these challenges, and to encourage flipping of Hold Co.(s) back in India, the Committee has recommended to exclude mergers from the purview of the NCLT and other complex processes and has suggested to implement a process similar to 'Fast Track Merger' as notified under Section 233 of the Companies Act, 2013, for the mergers in IFSC region.

2.4. Relaxing the overseas investment limit for AIFs and Mutual Funds: The SEBI regulated AIFs and Mutual Funds can respectively make overseas investments up to the aggregate limit set by RBI (viz. USD 1.5 billion for AIFs and USD 7 billion for Mutual Funds). The Committee recognized that owing to such limit, the innovators/start-ups in IFSC (which is considered as an offshore jurisdiction) may remain deprived of Indian capital. The Committee accordingly suggested that investments into IFSC entities by AIFs and Mutual Funds be exempted from the aggregate limit set by the RBI. The relaxation would also give IFSC a significant boost compared to other overseas jurisdictions due to the participation of Indian AIFs and Mutual Funds.

2.5. Deferred consideration: The deferred consideration clause is often built-in M&A agreements for diligence and other findings. Presently, deferment of purchase consideration, in case of transfer of equity instruments from resident to non-resident, is capped at 25% and entails RBI approval if deferment period extends over 18 months. The Committee recommended rationalizing such deferment provisions, and suggested widening the deferment tenure, and increasing the cap limit of deferred consideration.

2.6. Rationalizing escrow arrangement with global practice: The escrow arrangements become critical in case of exit arrangements in start-ups where the investors are offered exit opportunities in phased manner. While RBI has permitted usage of escrow accounts, there remains certain differences in usage of escrow arrangements in India and globally – key points of difference being the following:

a) Maximum escrow tenure is 18 months in India, whereas globally the escrow tenure for indemnities extends to 3-4 years.
b) Escrow account in India do not bear interest, whereas globally, the interest on escrow accounts is allowed to be accrued.
c) RBI approval is required for making payment against indemnity claims if it's not in line with the prescribed parameters, whereas, globally, the debits for indemnity claims are permissible and are driven by contractual terms.

Taking cognizance of the above, the Committee recommended rationalizing the escrow arrangements by way of aligning the relevant governing rules with the global practices.

2.7. Tax incentives: The Committee noted that favourable tax regimes lower tax rates and various tax incentives are the key reasons for start-ups domiciling their Hold Co.(s) to overseas jurisdictions, and thus suggested creating a favourable tax regime for Hold Co.(s). The suggestions revolve around ensuring tax neutrality on relocation to IFSC, exemption on capital gain tax on transfer of shares, concessional tax regime for dividend received by IFSC Company from subsidiaries, enhanced tax holidays etc.

3. **Administrative and other peripheral matters:**

3.1. Easy entry and exit: From an entry perspective, it is recommended that all applications for incorporation of companies or setting up of branch offices in GIFT IFSC should be processed by a dedicated MCA official in the Gift IFSC. Additionally, a 'Common Application Form' to consolidate company incorporation and IFSCA approval under one roof is also suggested.

Additionally, recommendation has been made to rationalize and improvise the exit process/winding up framework. The suggestions include providing of timelines for expeditious issuance of NOCs from all concerned departments, notifying a framework similar to 'fast track insolvency process' notified under Sections 55 to 58 of the IBC[7] for the winding up of entities situated in IFSC.

3.2. Expeditious recognition of IFSC entities as 'start-ups': Presently, entities planning to set up a unit in IFSC as start-ups, are required to obtain dual registration – i.e., IFCSA registration for setting up a unit in IFSC, and IMB[8] registration for being recognized as 'start-ups' for availing the benefits that are available to start-ups. The Committee recommended to fast-track the process for recognizing IFSC entities as 'start-up', and in this context, suggested that IFSCA should explore possibility of entering into an understanding with DPIIT to the effect that IFSCA registration can be relied upon by IMB for granting 'start-up' recognition.

3.3. Addressing challenges pertaining to Indian Intellectual Property (IP) Laws: The Committee took cognizance of the many prevalent IP related issues and made recommendations to suitably address the same. The recommendation *inter alia* revolved around setting a review Committee to analyse causes of delay in patent and trademarks; assessing the Delhi High Court recommendation to include software and business methods under patentable matter etc.

3.4. Special courts and advance ruling authority in IFSC: The Committee recommended establishment of special courts in IFSC for expeditious adjudication of the issues related to Company Law, IPR, and for efficient dispute resolution including enforcement of arbitral awards. Additionally, the Committee recommended setting up an advance ruling authority to address any questions that the investors/entrepreneurs may have with respect to applicability of regulations (tax or otherwise) or pertaining to company structures/business models etc.

Conclusion: The GIFT IFSC has been developed with the objective of "Onshoring the Offshore" and is envisaged as a gateway for global capital inflows into and out of the country. Thus, the objective of reverse flipping, as underlined in the Committee's report, mingles very well with IFSC's overall objective. The recommendations, if accepted, would accelerate the start-ups to move their domicile back to India from the overseas jurisdictions.

Besides, the Committee report is aligned with the vision of IFSCA to promote the establishment of '*World-Class FinTech Hub*' and to bolster innovation in the fintech industry by proposing attractive liberating measures for fintech start-ups thereby ensuring maximum relocation of fintech players to IFSC. The Committee's proposal, if accepted, may turn out to be a game changer, and one may witness start-ups flipping their domicile to IFSC.

[7] Insolvency and Bankruptcy Code, 2016

[8] Inter-Ministerial Bard set up by the Department for Promotion of Industry and Internal Trade

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