dhruva

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Externalization and SPAC listings in the Indian context

Introduction

Global business models, need for overseas capital, availability of a deeper investor pool, better valuations, and stronger intellectual property laws have provided significant impetus to externalization over recent years. This has especially caught the fancy of Indian startups and new age companies. Externalization as a concept refers to flipping the ownership of an Indian company to an overseas holding company. Externalization of holdings is an involved exercise entailing tax and regulatory considerations which need to be planned efficiently.

Externalized holdings have also ensured a heightened interest in Special Purpose Acquisition Companies (SPACs), which are emerging as a viable alternative to traditional IPOs, with lucrative valuations and accelerated listing on overseas bourses. In 2020 particularly, the number of SPAC IPOs in the USA was five times that of 2019, translating into a record of over USD 80bn funds raised, constituting half of the total IPOs in the USA.

In the Indian context, several issues arise with listing Indian companies overseas or with the migration of shareholding to overseas jurisdictions, and likewise for mergers with overseas entities. The recent spurt in SPAC listings in US markets is expected to shift the focus onto Indian companies' merging into these SPACs and listing overseas.

This flyer attempts to broadly outline some of the key discussion points around externalization and SPACs - the need for externalization, the areas warranting attention, potential structures, and how Dhruva can assist in this process.

The need for externalization

Deeper liquidity, lower cost of equity capital and a broader investor fraternity base

Attracts foreign investors who prefer familiarity with the regulations and tax regime of their home jurisdictions

Better realization of business potential and higher business valuations

Facilitates overseas listing

Provides a deeper and evolved understanding of non-traditional business models

Attracting global talent and deepening R&D

Current landscape

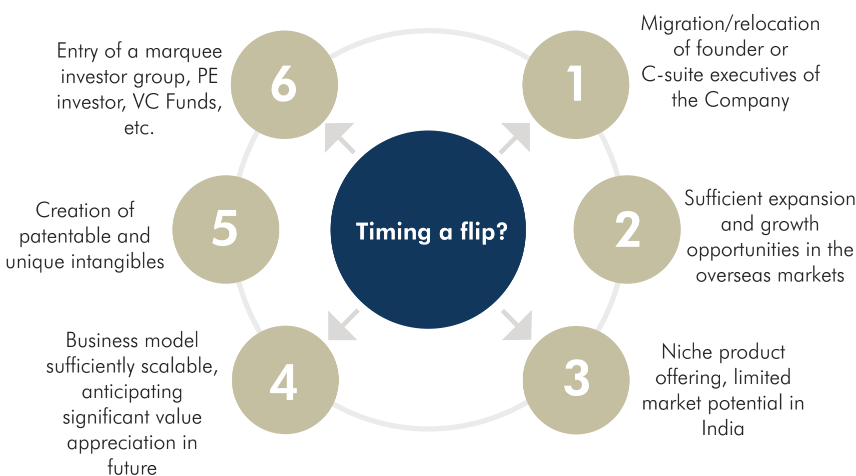
Possible avenues for Indian companies to access international capital markets without externalization

Indian companies can only access foreign equity capital markets by issuing depository receipts, i.e. Global Deposit Receipts (GDRs) and American Deposit Receipts (ADRs). This route is restrictive and is available only for listed Indian companies.

Potential options for unlisted companies to access international capital markets

Once the detailed guidelines are prescribed, requisite changes would also be required in various legislation, including Exchange Control laws, SEBI listing requirements, and Income-tax laws, in order to make overseas listing fully operational and efficient for Indian companies.

Even as the landscape for the overseas listing of Indian companies continues to evolve, Indian unicorns' increased need for global capital should be addressed with a smooth regulatory framework for externalization and SPAC listings.



Externalisation – Key areas for consideration

Holding Company jurisdiction

- One needs to consider access to the global investor pool, the availability of skilled manpower and senior professionals, the ease with which one can tap into intended markets, the impact on valuations, tax incentives, and the legal protection available for IPOs.

Exchange control laws and other Regulations:

- Externalization typically results in an overseas entity with all of its investors (including Indian investors) invested in it, and which in turn has investments in an Indian subsidiary. This results in a 'round-trip structure' (i.e. India→Overseas→India), also commonly known as economic round-tripping, requiring prior Reserve Bank of India (RBI) approval. It becomes paramount to substantiate commercial and business rationale for setting up the overseas holding company for such cases.
    - In our experience, the RBI has allowed applications for the approval of economic round-trip structures on a case-by-case basis upon being satisfied with the commercial/ business need for having such a structure.
    - A post facto detection attracts a compounding penalty and also increases the risk of unwinding. In certain cases, it has been observed that the RBI has permitted the regularization of such structures as well.
    - Individual investors in Indian companies may be restricted from investing in overseas companies beyond the limits specified under the Liberalized Remittance Scheme (LRS). Investors investing through an SPV, i.e. companies or LLPs, need to comply with extant exchange control regulations for investment in overseas entities (e.g. an investment limit of 400% of net worth, restrictions on more than one layer of SPV, etc.)

- Additionally, it may be critical to determine whether investments by individuals in overseas holding companies are portfolio or non-portfolio in nature. If regarded as non-portfolio in nature, the investment may trigger additional compliances including restrictions on the setting up of step-down subsidiaries.
- One needs to be mindful of obligations for Indian resident investors to remit sale proceeds to India at the time of future exits.
- One would also need to consider other sectoral regulations such as those applicable to Non-Banking Financial Companies, Core Investment Companies, Insurance, and other entities operating in the financial sector, etc. that may be relevant.

Income-Tax

- Externalization usually results in the transfer of the shareholding of an Indian company, triggering tax on capital gains income in the hands of the investors. Tax efficient structures in this regard can be considered.
- Certain key tax issues which need to be planned include the availability of grandfathering benefits under tax treaties, the preservation of the cost base and the period of existing holdings for shareholders, the ability to secure a cost step-up, income upstreaming, and General Anti-Avoidance Rules (GAAR), etc.
- One needs to be cognizant of certain tax issues arising post-externalization as well, including potential India-level taxability on the sale of shares of overseas companies on account of rules surrounding indirect transfer in India. A reconsideration and reorganization of business models may help to address such issues.

Transfer Pricing

- Often externalization involves the migration of intellectual property (IP) such as brands, patents, trademarks, copyrights, know-how, etc. as an essential element of the entire exercise. Companies also need to plan future development and maintenance of such IPs, warranting a thorough transfer pricing evaluation.
- Costs and profits arising from exploitation of intellectual property must be benchmarked and allocated to group entities performing DEMPE[1] functions.

Substance

- Adequate substance in the overseas holding company should also be created to mitigate any concerns around treaty eligibility, including provisions of Multilateral Instruments, Permanent Establishment (PE), and the place of effective management provisions under Indian Income-tax law.

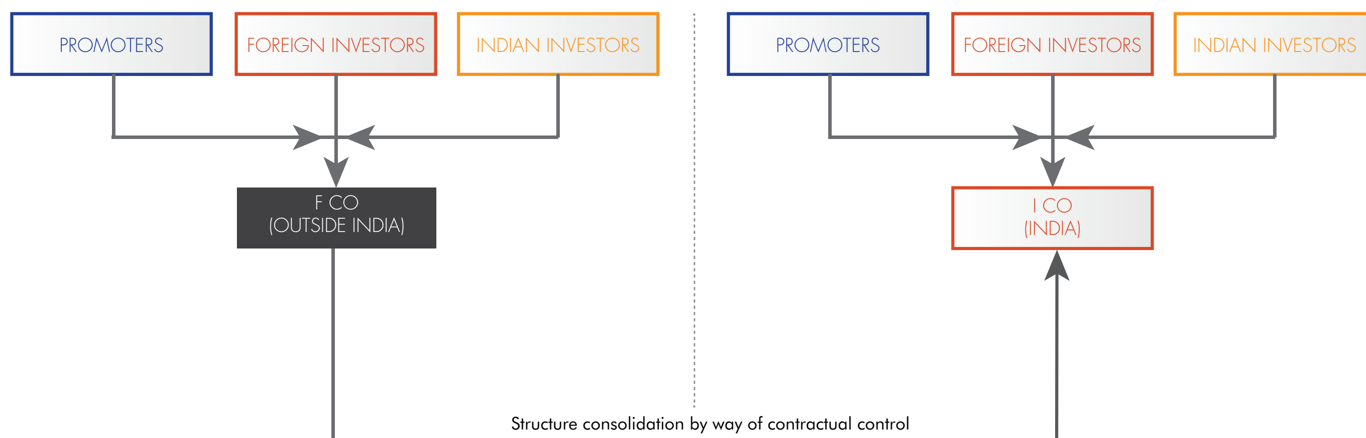
Migration of ESOPs and employment contracts

- Externalization also requires issuance of ESOPs by the overseas holding company to employees of the Indian subsidiary. It may also trigger a relocation of certain employees in India to overseas jurisdictions.
- This requires examining existing ESOP offerings and gathering an understanding of the different stages at which ESOPs exist, finalizing rollover plans, evaluating tax and regulatory implications (including the treatment of ESOPs already granted), and handling documentation and communication strategy for employees, amongst various other things.
- Employment contracts at overseas holding company level should be structured by duly factoring in aspects around fixed place and service PE issues.

Prevalent structures

Mirror structure

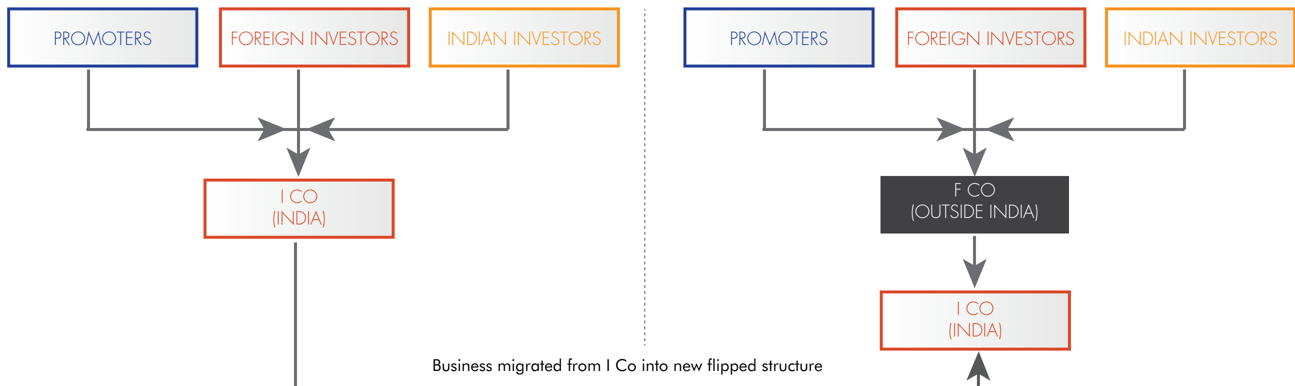
- Under this option, the Indian entity and the overseas holding company co-exist and operate in parallel. This option can be evaluated when there are restrictions from a regulatory perspective for Indian investors making an investment in an overseas entity.
- Control and value consolidation in such structures are exercised through contractual arrangements.
- This requires appropriate planning for administrative and contractual aspects as well as future exits.



[1]DEMPE refers to Development, Enhancement, Maintenance, Protection and Exploitation

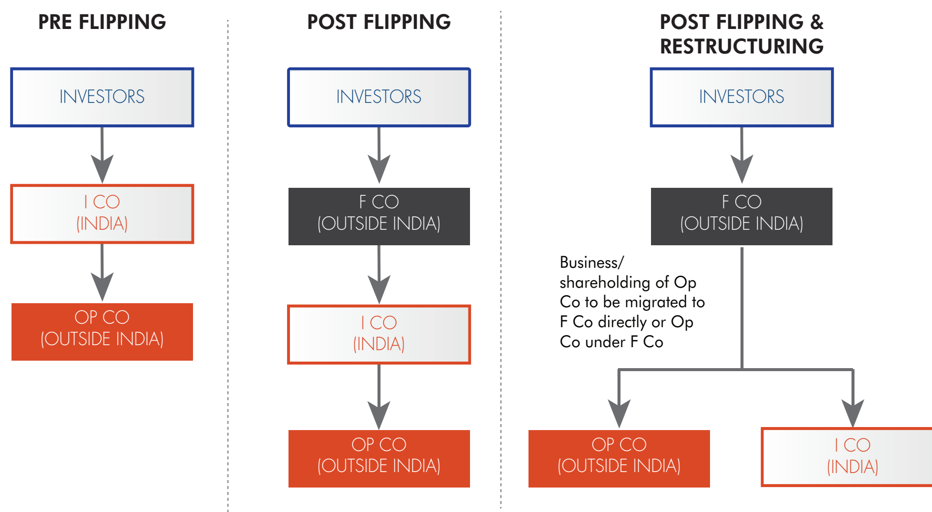
Flip structure

- This option entails the migration and mirroring of the capitalization table from the existing Indian company to the overseas holding company, and the subsequent re-alignment/consolidation of the Indian business under the overseas holding company structure.
- Various options are available for consolidating the Indian company's value under the overseas holding company structure. One could achieve a full or partial externalization, depending upon the shortlisted options.



Restructuring of Sandwiched structures

- Externalization of holdings with overseas businesses/subsidiaries may result in the problem of sandwiched structures. These structures are riddled with tax inefficiencies and call for a migration of the business/shareholding of overseas companies directly under the overseas holding company.



SPAC and Indian experience

- SPACs help to achieve listing for the externalized business. In summary, a SPAC is a "blank check" company that conducts an IPO to raise funds for investment in a business which is identified/to be identified.
- With an upswing in the popularity of SPACs, Indian companies are seen as attractive targets. Few precedents of SPAC listings exist in India.

There have been cases of India-focused SPAC entities such as Trans-India Acquisition and Phoenix India Acquisition.

In 2015, Silver Eagle Acquisition acquired a 30% stake in Videocon d2h for approximately USD 200 million.

In 2016, Yatra's parent c on NASDAQ by way of a with another US-based SI Acquisition.

Recently, Renew Power adopted the SPAC route for achieving overseas listing when it announced an agreement to merge with RMG Acquisition Corp II, a SPAC.

A recent news article[2] named Flipkart, Swiggy, Delhivery, Grofers etc. as being likely to pursue the SPAC route for achieving listing in overseas markets.

- Recently, the Securities and Exchange Board of India (SEBI) has also set up an expert committee to explore the viability of formulating rules and regulations for SPACs to be formed and listed in India.

[2] https://www.livemint.com/market/stock-market-news/spacs-the-new-buzzword-in-stock-exchanges-11616519873153.html

Flip externalisation structure for SPAC

- As a part of the de-SPAC process, the SPAC entity merges with the overseas holding company or acquires the shares of the overseas holding company. As a result, the ownership of the Indian company is transferred to the listed company overseas and the public shareholders of the SPAC migrate as shareholders of said overseas listed company.

STRUCTURE – POST EXTERNALIZATION

PROMOTERS
FOREIGN INVESTORS
INDIAN INVESTORS
F CO
(OUTSIDE INDIA)
I CO
(INDIA)

SPAC STRUCTURE

PUBLIC INVESTORS
SPONSOR HOLDING COMPANY
Public shares and Public warrants
Founder shares and Founder warrants
SPAC

POST DE-SPAC STRUCTURE

PROMOTERS
FOREIGN INVESTORS
INDIAN INVESTORS
PUBLIC INVESTORS
SPONSOR HOLDING COMPANY
Public shares and Public warrants
Founder shares and Founder warrants
SPAC
I CO
(INDIA)

Conclusion

The SPAC bandwagon is moving at a brisk speed. If the recent activity is any indication, SPACs are fast emerging as a mainstream listing route, especially for companies in the technology and ESG (environmental, social, and governance) sectors. Clearly, any SPAC or externalization requires detailed examination of a gamut of legal, tax and regulatory issues, with a final decision necessitating a careful calibration of all considerations and factors involved.

How can Dhruva assist?

Evaluation of potential structures for restructuring of the existing business model and ownership
- Review of existing structure
- Understanding the commercial requirements
- Identification of alternate structures considering the commercial and regulatory framework

Detailed impact analysis
- Identification of the tax-efficient jurisdiction for incorporation of an overseas company
- Analysis of the Indian tax and regulatory implications
- Partnering with overseas advisors/ law firms to understand overseas tax and regulatory implications
- Assistance in finalization of the structure(s) and decision making

End to end implementation support
- Detailed mechanics and activity chart
- Suggesting best practices and safeguards
- Assistance in obtaining necessary approvals/ permissions in India
- Assistance in necessary internal documentation, including on inter-company arrangements, benchmarking studies, etc
- Assistance in deal documentation for the SPAC merger

ABOUT DHRUVA ADVISORS

Dhruva Advisors LLP is a tax and regulatory services firm, working with some of the largest multinational and Indian corporate groups. Its brings a unique blend of experience, having worked for the largest investors in India, advising on the largest transactions and on several of the largest litigation cases in the tax space. We also work closely with the Government on policy issues and with our clients on advocacy matters.

Key differentiators:

- Strategic approach to complex problems
- In-depth, specialised and robust advice
- Strong track record of designing and implementing pioneering solutions
- Trailblazers in tax controversy management
- Long history of involvement in policy reform
- Technical depth and quality

We believe in thinking out of the box, handholding our clients in implementing complex solutions and working towards achieving results. We have offices in Mumbai, Ahmedabad, Bengaluru, Delhi, Kolkata, Pune, Singapore, Dubai and New York. We advise clients across multiple sectors including financial services, IT and IT-enabled services (ITES), real estate and infrastructure, telecommunications, oil and gas, pharmaceuticals, chemicals, consumer goods, power, as well as media and entertainment.

Dhruva Advisors is a member of the WTS Alliance, a global network of selected firms represented in more than 100 countries worldwide.

Our recognitions

- Dhruva Advisors has been consistently recognised as the "India Tax Firm of the Year" at the ITR Asia Tax Awards in 2017, 2018, 2019 and 2020.
- Dhruva Advisors has also been recognised as the "India Disputes and Litigation Firm of the Year" at the ITR Asia Tax Awards 2018 and 2020.
- WTS Dhruva Consultants has been recognised as the "Best Newcomer Firm of the Year" at the ITR European Tax Awards 2020.
- Dhruva Advisors has been recognised as the "Best Newcomer Firm of the Year" at the ITR Asia Tax Awards 2016.
- Dhruva Advisors has been consistently recognised as a Tier 1 firm in India's 'General Corporate Tax' and 'Indirect Tax' ranking tables as a part of ITR's World Tax guide. The firm is also listed as a Tier 1 firm for India's 'Transfer Pricing' ranking table in ITR's World Transfer Pricing guide.

Mumbai
One World Center, 11th floor,
Tower 2B, 841, Senapati Bapat
Marg, Elphinstone Road (West),
Mumbai 400013
Tel: +91 22 6108 1000/1900

Ahmedabad
B3, 3rd Floor, Safal Profitaire,
Near Auda Garden,
Prahladnagar, Corporate Road
Ahmedabad - 380 015
Tel: +91-79-6134 3434

Bengaluru
Prestige Terraces, 2nd Floor,
Union Street, Infantry Road
Bengaluru 560 001
Tel: +91-80-4660 2500

Delhi/NCR
101 & 102, First Floor,
Tower - 4 B, DLF Corporate Park
M.G. Road, Gurgaon
Haryana 122 002
Tel: +91-124-668 7000

Pune
305, Pride Gateway,
Near D-Mart, Baner,
Pune - 411 045
Tel: +91-20-6730 1000

Kolkata
4th Floor, Unit No 403,
Camac Square, 24 Camac Street,
Kolkata, West Bengal – 700016
Tel: +91-33-6637 1000

Singapore
Dhruva Advisors (Singapore) Pte. Ltd.
20 Collyer Quay, #11-05
Singapore - 049319
Tel: +65 9105 3645

Dubai
WTS Dhruva Consultants
Emaar Square Building 4, 2nd Floor,
Office 207, Downtown,
P.O.Box 127165,
Dubai, United Arab Emirates
Tel: +971 4 240 8477

Key Contacts:

MUMBAI
Dinesh Kanabar
CEO
dinesh.kanabar@dhruvaadvisors.com

MUMBAI/AHMEDABAD
Mehul Bheda
mehul.bheda@dhruvaadvisors.com

BENGALURU
Ajay Rotti
ajay.rotti@dhruvaadvisors.com

DELHI/NCR
Vaibhav Gupta
vaibhav.gupta@dhruvaadvisors.com

PUNE
K Venkatachalam
k.venkatachalam@dhruvaadvisors.com

KOLKATA
Aditya Hans
aditya.hans@dhruvaadvisors.com

SINGAPORE
Mahip Gupta
mahip.gupta@dhruvaadvisors.com

DUBAI
Nimish Goel
nimish.goel@dhruvaadvisors.com

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