ONSHORING THE OFFSHORE – A GIFT TO INDIAN INNOVATORS

Tax considerations in the Expert Committee Report titled "*Onshoring the Indian Innovation to GIFT IFSC*"

1. INTRODUCTION

1.1. Indian startup ecosystem has evolved considerably since the early days of economic liberalization. The startup ecosystem has become an engine of growth and job creation, transforming India into a global hub of innovation and entrepreneurship. Today, India has emerged as the third largest ecosystem for startups globally, with third highest number of unicorns. As per the Economic Survey 2022-23[1], India has become the most innovative nation in the lower middle-income group overtaking Vietnam and leading the Central and Southern Asian Region.

1.2. While, on one hand, India's startup ecosystem is achieving remarkable growth, on the other hand, a trend of Indian startups externalizing / flipping to offshore jurisdiction has been daunting.

2. EXTERNALIZATION / FLIPPING

2.1. 'Externalization' or 'Flipping' refers to a process whereby the entire ownership of an Indian startup (along with potentially all intellectual property and data) is transferred to an overseas holding company ("**Offshore HoldCo**"). Such process of externalisation or the flight of innovation to overseas jurisdiction/(s) effectively transforms an Indian start-up company into a wholly owned subsidiary of an Offshore HoldCo with founders and investors retaining the same ownership through such Offshore HoldCo.

3. KEY FACTORS FOR EXTERNALISATION

3.1. The process of externalisation or flipping is motivated by several factors ranging from a favourable tax regime, access to foreign capital, prospects for better valuation and ease of operations.

3.2. Tax arbitrage, however, remain one of the most influential factors. For example, India's average corporate tax rate (25.17%) is significantly higher than the corporate tax rate in countries such as Singapore (17%), USA (21%), and UK (19%). Certain overseas jurisdictions offer additional tax benefits such as reduced personal tax rate, participation exemption, capital gains tax exemption, no thin capitalisation rules, etc – which encourages promoters / investors to set-up Offshore HoldCos.

4. IMPACT OF EXTERNALISATION

4.1. Externalization creates a peculiar situation for Indian startups, where the founders are generally Indians, the majority of employees are Indians, the activity being carried out is predominantly in India, but the holding company is domiciled offshore. Such an

[1] https://www.indiabudget.gov.in/economicsurvey/

externalisation results in movement of management, intellectual property, value creation, capital raising, etc; from India to the overseas jurisdiction.

4.2. As per estimates, 56% of 108 Indian Unicorn startups are domiciled in offshore jurisdictions[2] - with US, Singapore and UK being the most popular countries where Indian start-ups are domiciled.

4.3. Externalisation impacts the Indian economy in several ways as under:

- **Economic loss and brain drain of entrepreneurial talent:** Externalisation results in relocation of founders and other key managerial persons outside India depriving Indian economy of their potential contributions. This process of brain drain leads to loss of human capital, as well as stalls innovation and technological advancements within the country.

- **Loss of Intellectual Property and Technology leakage:** Externalisation also results in transfer of IP and technology outside India primarily due to robustness of IP laws and enforcement mechanism in overseas jurisdictions such as in USA and Singapore.

- **Tax revenue loss:** Externalised Offshore HoldCos pay lower corporate tax in the overseas jurisdiction with respect to value created outside India – resulting in revenue loss in the source country, such as in India.

5. ROLE OF INDIAN GOVERNMENT AND IFSCA IN ONSHORING INDIAN STARTUPS AND SETTING UP OF A COMMITTEE

5.1. Government of India have taken various initiatives to integrate the Indian economy with global financial system. One of the prominent initiatives, is to set-up and operationalise India's maiden International Financial Services Centre ("**IFSC**") in Gujarat International Finance Tech City ("**GIFT IFSC**").

5.2. One of the primary objectives of GIFT IFSC has been to "***Onshore the Offshore***" i.e., to bring back the financial transactions and services business carried out in overseas jurisdictions by Indian entities. Government of India has time and again introduced several favourable amendments in the Income Tax Act, 1961, to facilitate a competitive tax regime for GIFT IFSC in comparison with overseas jurisdictions.

5.3. In line with its primary objective to *Onshore the Offshore*, GIFT IFSC is uniquely positioned to onshore the Indian startups that have flipped to overseas jurisdictions and has become an ideal choice for reverse flipping of these Indian startups.

5.4. International Financial Services Centres Authority (IFSCA) constituted a Committee of Experts[3] ("**Committee**") to make suggestions on onshoring the Indian innovation to GIFT IFSC. The Committee was chaired by Shri G. Padmanabhan, Former Executive Director, RBI; and comprised of representatives from venture capital funds, startups, fintech firms, law firms and other domain experts. The general terms of reference of the Committee were as follows:

a) Suggest measures to encourage the Indian Fintech / Startups domiciled abroad to relocate to GIFT IFSC.

[2] Data from 3one4 capital
[3] https://ifsca.gov.in/IFSCACommittees#

b) Identify issues that may be critical for development of GIFT IFSC as a global Fintech Hub.

c) To encourage new Fintechs having global outlook to setup commercial presence in GIFT IFSC.

d) Any other suggestions for development of International Innovation Hub at GIFT IFSC.

5.5. The Committee submitted its report to the Chairperson, IFSCA in August [4]2023.

6. OBJECTIVE OF THIS ARTICLE

This article attempts at summarising some of the key tax issues identified by the Committee and their recommendations to facilitate an environment that encourages reverse flipping of Indian startups.

7. TAX PROPOSALS

The Committee acknowledges that to incentivize the Offshore HoldCos to shift back to India, the tax regime in India should either be more favourable or at least be at par with the offshore jurisdictions. Considering this overarching objective, the Committee recommends a tax regime that, at a minimum, provides for the following:

(a) Tax neutral relocation of Offshore HoldCo to GIFT IFSC.

(b) Tax neutrality for investors and shareholders of Offshore HoldCo.

(c) Grandfathering of existing investment of Offshore HoldCo and ensuring there is no additional tax on disposal of existing investments post relocation / migration.

(d) Tax compliances for investors / shareholders to be at par with those existing with Offshore HoldCo.

(e) No lapse of losses of the Indian operating entity due to relocation.

(f) No lapse of India losses of Offshore HoldCo due to relocation.

Some of these proposals and certain additional recommendations of the Committee are discussed in greater detail as follows.

8. TAX NEUTRAL RELOCATION OF OFFSHORE HOLDCO TO GIFT IFSC AND EXEMPTION FOR SHAREHOLDERS / INVESTORS

The Offshore HoldCo could be relocated, or reverse flipped to India through various modes, such as transfer of shares by Offshore HoldCo to a GIFT IFSC holding company; or merger of Offshore HoldCo into GIFT IFSC holding company; or swap of shares by shareholders in Offshore HoldCo for shares / securities in GIFT IFSC holding company; or re-domiciliation of Offshore HoldCo to GIFT IFSC, thereby becoming an Indian company. Currently, each of these methods would create a tax liability in India either for the Offshore HoldCo, for the shareholders, or both.

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[4] https://ifsca.gov.in/ReportPublication/index/aadg9ruDI%20M=

In order to incentivise relocation of Offshore HoldCo to GIFT IFSC in a tax efficient manner, the Committee proposes the following:

(a) Relocation: Currently, the Income Tax Act, 1961, provides tax neutrality for transfer of specified funds[5] from offshore to GIFT IFSC. Amendments to this effect were introduced in the Finance Act, 2021. However, similar exemption is not available for relocation of Offshore HoldCo. The Committee recommends similar amendments to ensure tax neutrality on relocation of Offshore HoldCos to GIFT IFSC.

(b) Multi-layer structure: In the case of multi layered structure, where certain additional steps are required to collapse the structure into GIFT IFSC holding company, tax neutrality should be provided for each step.

(c) Grandfathering: To bring parity with the situation as if the Offshore HoldCo had not relocated, grandfathering benefit should be extended to existing investments of Offshore HoldCo. This will ensure that there is no additional tax on disposal of such investments post relocation (which otherwise were not chargeable to tax).

(d) Cost of acquisition and period of holding: The Committee recommends that the cost of acquisition and period of holding in the hands of Offshore HoldCo becomes the cost and the period of holding of GIFT IFSC holding company, post relocation.

(e) Compliance obligations: To ensure parity with the situation as if the Offshore HoldCo did not relocate to GIFT IFSC, the Committee recommends exemptions for non-resident shareholders from compliance obligations – such as obtaining PAN and filing return of income.

(f) Lapse of losses: Under the current provisions, certain Indian operating companies and startups, will lose its ability to carry forward and offset business loss if there is change in beneficial ownership by 51% or more. The Committee recommends that business loss of Indian operating companies should not lapse due to flipping of the structure to GIFT IFSC.

(g) Lapse of Indian losses of Offshore HoldCo: If the Offshore HoldCo has India related capital loss, it is eligible to carry forward and offset such loss for 8 years. However, if it relocates to GIFT IFSC, the GIFT IFSC holding company cannot carry forward such loss incurred by an erstwhile Offshore HoldCo. The Committee recommends that such losses of Offshore HoldCo should be made available to GIFT IFSC holding company as well.

9. PARTICIPATION EXEMPTION FOR GIFT IFSC HOLDING COMPANY

9.1. Holding company structure is generally set-up with a strategic outlook considering potential exits / sale in future or internal reorganisation. Certain tax and business friendly jurisdictions

[5] Specific tax exemption is available on relocation of certain Specified Funds to GIFT IFSC. Capital gains arising on transfer of capital asset is exempt for such Specified Funds; further, capital gains arising on transfer of share held in Specified Fund in consideration for share in the resultant fund in GIFT IFSC, is also exempt in the hands of the shareholder. Specified Fund means "original fund" (i) Established outside India, which collects funds from its members for investing it for their benefit, subject to fulfilment of prescribed conditions; or (ii) an investment vehicle, in which Abu Dhabi Investment Authority is the direct or indirect sole shareholder and such investment vehicle is wholly owned and controlled, directly or indirectly, by the Abu Dhabi Investment Authority or the Government of Abu Dhabi. Further, "resultant fund" in GIFT IFSC means fund established in India in the form of a company / trust / LLP, registered as Category I/II/III AIF and which is located in any IFSC.

such as Netherlands and Luxembourg provide for participation exemption for holding companies – meaning there is exemption available from capital gains tax and certain other benefits, in connection with its subsidiary companies.

9.2. Presently, no such participation exemption is available for holding companies in India. In order to bring the tax framework in line with best practices of the financial centres of the world, the Committee recommends introducing participation exemption for holding companies in GIFT IFSC, subject to certain threshold or ownership criteria to be satisfied by such holding companies.

10. RATIONALISATION OF TAX RATES FOR CAPITAL GAINS INCOME

10.1. Currently, long-term capital gains on disposal of unlisted equity shares of an Indian company varies depending upon the residential status of the investor. For example, capital gains income from sale of shares of an unlisted Indian company for a non-resident investor is taxed at the rate of 10% *(excluding surcharge and cess)* – without indexation and foreign exchange fluctuation benefit. However, for resident investor it is taxed at 20% *(excluding surcharge and cess)* – with indexation benefit.

10.2. On relocation, Offshore HoldCo will be treated as a resident of India, hence, long-term capital gains on sale of unlisted shares will be subject to tax at 20% instead of 10%. The Committee recommends that on relocation of Offshore HoldCo, the tax implications should remain at par as if no relocation had taken place. In other words, the same tax rate of 10% should be applicable should GIFT IFSC holding company sell shares of Indian operating companies.

11. CONCESSIONAL TAX REGIME FOR DIVIDEND RECEIVED AND DISTRIBUTED BY GIFT IFSC HOLDING COMPANY

11.1. A holding company housed in GIFT IFSC is likely to receive dividends from various subsidiaries and also distribute dividend to its shareholders.

11.2. Offshore HoldCos, in jurisdictions such as Singapore and Luxembourg, enjoy exemption from tax in respect of dividend earned from subsidiary companies. Currently, there is no exemption / concessional tax in India with respect of dividend from subsidiary companies, though a deduction is available in respect of inter-corporate dividend. Such deduction is however conditional and would be available only if the dividend income is redistributed within the specified time frame by the holding company in India.

11.3. The Committee recommends extending tax exemption for dividend received by a holding company in GIFT IFSC to make it competitive with tax regime in prominent financial services jurisdiction. The exemption can be extended based on satisfaction of certain conditions / criteria, either based on percentage of shareholding or equity participation meeting certain acquisition value.

11.4. The Committee also recommends that in order to mitigate any cascading tax burden on account of dividend distribution among multiple entities / SPVs within GIFT IFSC, tax exemption should be granted to dividend income earned by GIFT IFSC holding companies from subsidiaries / SPVs also located in GIFT IFSC.

12. RESIDENTIAL STATUS OF FOREIGN SUBSIDIARIES – ADDRESSING POEM CONCERNS

12.1. A foreign company is treated as a "resident" of India if the place of effective management ("**PoEM**") of such company is in India. PoEM means a place where key managerial and commercial decisions that are necessary for the conduct of the business of an entity as a whole, are in substance made.

12.2. The Committee recommends that in case of relocation of offshore HoldCo to GIFT IFSC, there should be no adverse tax consequences for the subsidiaries of GIFT IFSC holding companies merely because its effectively managed in India through the GIFT IFSC holding company. This can be ensured by way of an express clarification that PoEM will not be triggered merely because the holding company is based in GIFT IFSC.

13. ANGEL TAX EXEMPTION

13.1. Angel tax has invited a lot of attention and criticism particularly since the scope of angel tax provisions were extended to non-resident investors. In fact, this has become one of the key factors for some startups to flip the structure outside India and fall outside the scope of angel tax provisions.

13.2. In order to encourage flipping of offshore holding company into GIFT IFSC and for that matter even to encourage greenfield investments in holding companies to be setup directly into GIFT IFSC, the Committee recommends that angel tax provisions should not apply to GIFT IFSC holding companies.

14. TRANSFER TAX IN OFFSHORE JURISDICTION

14.1. The Committee acknowledges that while India may provide tax neutrality in relation to reverse flipping of offshore holding company into GIFT IFSC, such reverse flipping may be taxed in the offshore jurisdiction. Such tax payment could be potentially substantial and may act as a deterrent for offshore holding company to shift to GIFT IFSC at the initial stage itself.

14.2. To mitigate this adverse consequence, the Committee recommends that Indian startups may be allowed to carry forward the losses or be provided 20-year tax holiday instead of the existing 10-year holiday.

15. PERSONAL TAX FOR SKILLED NON-RESIDENT INDIVIDUALS

15.1. Several countries, including Singapore, Hong Kong, UAE, Caymans Island and Switzerland, have gained popularity among entrepreneurs and professionals due to their lower personal income tax rates - ranging from 9% to 22%.

15.2. In contrast, India currently imposes a personal tax rate of 30% plus surcharge and cess ranging between 10% to 37% - resulting in a tax rate of 42.7%. This is significantly higher than rates prevalent in other competitive jurisdictions.

15.3. Accordingly, to boost relocation of these non-resident skilled professionals employed with Offshore HoldCos, India should consider aligning its personal income tax rates for such non-resident individuals with the competitive jurisdictions such as Singapore, UAE, etc. To achieve this, the Committee recommends that India may consider implementing a lower tax rate (preferably less than 20%) on the income earned by the highly skilled non-resident individuals relocating in GIFT IFSC along with the Offshore HoldCos.

16. CONCLUSION

The startups who have flipped to overseas jurisdictions are waiting for the right opportunity to shift back to India. The Economic Survey 2023 highlighted that startups are exploring "reverse-flipping", or shifting their domicile back to India, a month after it emerged that fintech unicorn PhonePe has paid withholding taxes on behalf of its investors to the tune of INR 8,000 crore (around $ 1 billion) on account of relocation[6].

The recommendations provided by the Committee, particularly from a tax perspective, are a steppingstone to reverse flip Offshore HoldCos to GIFT IFSC. If the recommendations are implemented, it can catapult GIFT IFSC into becoming a global hub for startups wanting to explore the Indian and the overseas market.

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[6] PhonePe's investors coughed up Rs 8,000 crore in taxes to shift domicile from Singapore to India: CEO Sameer Nigam (moneycontrol.com).