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Delaware Flip Model: Issues and Concerns of Corporate Governance and Foreign Investment

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Abstract

India's NPA crisis is deepening and banks are unable to lend to Indian businesses - large or small – as liberally as they used to in the past for new technologies, building start-ups, strategic expansion or R&D. This credit crunch has led to an economic slowdown and increase in unemployment among persons with college degrees. There is, therefore, an urgent need for the Government of India to come up with laws, regulations and policies to promote the market for private capital in India, such that Indian businesses may access alternate sources of capital for growth and innovation, i.e., through sources other than banks which have been the traditional source of financial capital in the India. Over the past few decades, venture capital in India has evolved from its nascent to its sophistication level. There are many hurdles for India's venture capital industry, foreign investment, since there is the absence of well-established or well-structured capital market. Regulatory obstacles are another major issue for venture capital investors in India. My paper deals with the issues of corporate governance and foreign investment in India. What are the laws for regulating foreign investment coming into India for both strategic and financial purposes? What are the Changes required in the Existing Taxation and Corporate Governance provisions? Most importantly, what the government should do to promote foreign investment in India?

Keywords: NPA, FEMA, FDI, FVCI, FPI, Delaware, VC

Introduction

India is considered as an emerging manufacturing hub in global value chains, as a growing consumer market. It is at the cusp of rapid digital transformation. In addition to this,

in such a rapidly changing geopolitical environment, India's large democracy and consistent reform initiatives are recognized by the MNCs. A tremendous development has taken place in India in the field of venture capitals funding in the past decades. It was the year of the 1986 which could be considered as a starting point of venture capitalism in India with the influx of economic liberalization.. According to KPMG report, there was a path breaking venture capital investment in India even in the fourth quarter of 2020. The Startup India Initiative of the Indian government is commendable for improving the regulatory mechanism for boosting start-ups ecosystem. For attracting investors and ensuring their protection, Indian government has started flagship program like "Digital India", "Make in India", etc. In this regard, the establishment of Alternative Investment policy Advisory Committee could be considered as a milestone for making policy and regulatory changes in offshore and onshore investments. Consequently, India's ranking in the "Ease of Doing Business" has increased from 130 in 2016 to 63 in 2019.

Such rapid development in the venture capital funding has given rise to the "flip" model which undoubtedly provides an attractive ecosystem and investor friendly jurisdictions to the Indian start-ups. Hence, this concept gained significant popularities in such a short period of time in the venture capital circles. A sense of security for investors in a holding company would be invaluable. Thus, investors would never want to be a part of such jurisdiction which has strict laws and heavy burden compliance. On the other hand, incorporating a holding company in Delaware is something which gives immense future possibilities for business to thrive. Being the most popular jurisdiction for investors, Delaware brings the most sophisticated, predictable and comprehensive laws even in the complex situations for incorporating a company. It provides structured set of corporate laws which comparatively makes the operations and incorporations quite smoother. The fascinating elements for holding company in Delaware could be in the form of low tax rate, international less capital gain tax at the time of acquisition. In addition to this, there is considerable relaxation in the corporate governance issues. For instance, it is sufficient for you to act with simple majority vote in case of being a stakeholder in Delaware which is not the case in other jurisdictions. Moreover, in case of merger, the consent of simple majority of shareholders is sufficient which could be considered as one of the reasons for attracting the potential acquirers. Creation of a company in the United States with the purpose of setting up the holding company of the international subsidiary would be known as Delaware Flip Transactions. All shareholders who particularly want to hold security in foreign company would exchange their equity or share in the in the newly formed company for the purpose of receiving the proportionate shares in Delaware corporations.

The research paper has addressed the key issues and challenges for Delaware flip transaction from Indian perspective. For instance, the issues of round tripping transactions, the restrictions on equity holding of Indian parties, rights of shareholders and managers are covered. Moreover, the changes in the existing laws from Indian regulatory perspective in the form of duties of directors, private placement, compulsorily convertible debentures and exchange control are also discussed in details. Some of the changes are positive for the foreign investment whereas some of them are negative. Changes have taken place in the existing Indian tax legislation as well like capital gains tax, pass-through status, foreign account tax compliance Act. Finally, I have given my constructive suggestions and conclusions as to how to boost the foreign investment in India.

What Is Delaware Flip Model and Why Is It in Debate

Delaware Flip Model is creation of a company in the US for the purpose of considering it a holding company of an international subsidiary. An international holding company is

incorporated by the Indian promoter who incorporates wherein the securities are subscribed by offering shares on share swap basis in its Indian counterparts. For example, there is a start-up named "All-Well" with Indian promoters, seeking venture capital funding but they are not able to tap the market through a company based in India. Thereafter, they incorporate a company named "Blue-Well" in Delaware and being an Indian promoter, they possess the controlling interest. A share swap agreement was entered into by the promoter and the company "Blue-well". Hence, the company "Blue-well" purchases all the shares of company "All-well". Thereafter, "Blue-well" issues its shares as a part of exchange to "All-well".

There is no reasonable doubt that robust venture capital flows bring oceans of opportunities for India's future economy. Despite the Covid-19 pandemic, the venture capital investment has significantly increased. For instance, a strong deal of $ 10 billion in venture capital investment in 2020 has taken place. In addition to this, enormous fund-raising activity in terms of $ 03 billion was raised by India. There has been establishment of 7000 start-ups in the year 2020 itself having 10% growth in seed stage deals. In short, it could be concluded that venture capital investment has been the hallmark for bolstering the start-ups ecosystem in India.

Foreign Exchange Management Act, 1999

Foreign Exchange Management Act, 1999 (herein referred to as FEMA) regulates overseas direct investment. It is pertinent to note that the Reserve Bank of India (RBI) issues from time to time the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations 2004 (ODI Regulations) in consonance with Master Direction on Direct Investment by Residents in Joint Venture (JV) or wholly owned Subsidiary (WOS) Abroad and Liberalized Remittance Scheme, notification and direction. One of the important conditions is that there should be the existence of a bonafide business activity in case the Indian party wants to undertake the overseas direct investment in the JV or the WOS. In this regard, the round tripping restrictions under FEMA are very important. There is no definition of round tripping under Indian income tax law. However, the round tripping financing is applicable under General Anti Avoidance Rules (GAAR).

Changes in the Indian Laws: A Corporate Governance Perspective

Foreign Company

A company which has place of business in India either physically, agent or electronic mode and conducts a business activity in India is known as Foreign Company under the Companies Act, 2013. A company which has business operations in India is mandated to follow the local regulation and compliances which include filing of charter documents and filing reports, etc. Moreover, it is applicable on a foreign company to abide by the provisions of the Act. For instance, the issue of debentures, books of accounts, registration of charges and the power of registrar of companies for the purpose of inspection, inquiry and investigation.

Division of Company

There is no doubt that the 2013 Companies Act overhauled the India's previous company legislation and improved the corporate governance standards. In the growth of the economy, the role of the private company is undeniable. Since most of the start-ups take form of private companies, it is important to consider that such private companies should not be overburdened in terms of compliances. Hence, maintaining a smooth balance between regulation and relaxation is sine qua non. Under the 2013 Companies Act, a heavy burden has been imposed on the private companies. Moreover, there is no strong distinction between the

private companies and the public companies as compared to the 1956 Act. Apart from this, there is a positive development as well. One of the positive developments for public companies is a notification by the Ministry of Corporate Affairs while granting relaxation. It is pertinent to note that these exemptions are applicable to private companies which do not fall under the ambit of the subsidiary of public companies.

Private Placement

As per the 1956 Companies Act, the issuance of securities to private equity funds for the purpose of securing finance was straightforward given the corporate compliance. Nonetheless, under 2013 Companies Act, strict regulations have been imposed. Making a long list of disclosures to persons is mandatory for those who want to subscribe securities on the account of private placement. It is also important for private companies to obtain the valuation report upon which the offering price of the securities is based. This could be considered as overregulation which is not beneficial for sophisticated private equity and venture capital investors, since they are not willing to make extensive disclosures on the behalf of the company offering security. There is no any rationale as such for regulating the financial activities of private companies, since it do not make offer to public.

Duties of Directors

The liabilities of directors of a company have extensively been expanded as per the Companies Act, 2013. In case of occurrence of corporate wrongdoings, even the non-executive directors could be held responsible, because it will be assumed that he had knowledge of company's ongoing activities. In the context of Private Equity and venture capital, the portfolio companies carefully take into consideration the policies with regard to directors and officer liability insurance and indemnification of liability for their nominee directors. On the other hand, for promotion of corporate governance reform, the declaration of significant business ownership is mandatory under the 2013 Companies Act.

Compulsorily Convertible Debentures

For private equity and venture funds investment, compulsorily convertible debentures are quite popular instrument. The 2013 Act has introduced certain difficulties so far as structuring private equity and venture capital investment in compulsorily convertible debentures are concerned. For instance, the cap restriction on the conversion period of compulsorily convertible debentures is incorporated. It is mandatory that portfolio companies should provide significant security against CCDs.

Exchange Control

Foreign investment into Indian entities can be made through FEMA, 1999. The regulation of such laws is performed by the RBI. The foreign investment can be made either through Foreign Direct Investment (FDI) or Foreign Portfolio Investment (FPI) or Foreign Venture Capital Investor (FVCI). So far as the concept of control in India is concerned, it is not much clear. The Competition Act 2000, The Companies Act, 2013 and the Substantial Acquisition of Shares and Takeovers, 2011 have tried to define the contour of controls. For instance, all the above-mentioned laws have included the right to appoint the majority of directors, the right to exercise the policy decision and the management decisions, etc. are the portion of qualitative control. As per the Takeover Code, 2011, the numerical threshold of 25% is quite narrow for quantitative control. Due to this, acquirers face a lot of issues like expensive takeover at the time of acquisition. Consequently, it will create a negative impact upon acquirers and investors.

Changes in the Existing Laws: A Tax Legislation Perspective

Capital gains

The unpredictable tax environment in India is well-known to investors. This could be one of the main reasons that the private equity and venture capital funds investment suffer lots of heavily burden compliance. One of such issues is capital gains tax under the Income Tax Act, 1961. One of the continuous sources of uncertainties for private equity and venture capital funds is that subjective criteria have been used by the tax authority for fixing the income as 'capital income' or 'business income'. Though after much hue and cry, the tax authority has issued Circulars stating the objective criteria for determining the capital income. As a consequence of this, the recent Tax Circulars provide certainty for characterization of income from shares. Interestingly, the circular has given recognition to the two important concepts that a person is entitled is have two portfolio, namely, an investment portfolio and a trading portfolio.

According to the Tax Circulars, if one has acquired income from the listed shares within the period of 12 months prior to their sale, it will be surely deemed as capital gains. So far as the case of unlisted shares for determining capital gains is concerned, such period of 12 months do not matter. However, there are certain cautions which are supposed to be taken into consideration while determining concerned. For instance, the tax authority exercises the unlimited power to treat the income of a private company's shares as business income testing the genuineness of income and lifting of corporate veil. The transfer of control and management including shares are also the grounds which probably work as a bottleneck in terms of causing immense uncertainties for private equity funds and venture capital funds.

Pass-through status

The pass-through status was not granted to all kinds of funds under Alternative Investment Funds (AIF) which was registered as venture capital funds. The pass-through status is applicable to category 1 and 2 of the funds. Hence, pass-through status has been extended to all categories except the hedge funds.

Foreign Account Tax Compliance Act

In the year 2015, India made an agreement with the United States for the purpose of implementation of US legislation which is popularly known as Foreign Account Tax Compliance Act (herein referred to as FATCA). The intention of such legislation is to collect the tax information of the US citizens. The imposition of FATCA could be reflected in terms of heavy business compliance for Indian resident entities which have direct or indirect investment by the US residents. It fundamentally influences the onshore private equity and venture capital funds that are based on residents American LP. It is necessary for onshore private equity funds to perform due diligence, perform and to collect data related to their LPs so that the tax authority could be informed. The global problem of tax evasion could be solved while crafting the FATCA.

Challenges for Delaware Flip Model from Indian Regulatory Regime

There is the involvement of overseas direct investment (ODI) and foreign direct investment (FDI) while considering flip restructuring in the Indian context. First and foremost, for the purpose of setting up a holding company in a foreign jurisdiction, the money is supposed to be taken out of India and subsequently the invested money comes back in the subsidiary

company in India. For depicting illusionary growth and getting tax benefits it is profitable for companies. However, there could be no net economic substance which could be produced from such round tripping.

The issue arises regarding the round tripping at that point of time when domestic funds are back in the country in terms of foreign direct investment; and there is no any real incremental flow of funds. In this regard, the recent RBI's prohibition is a clear-cut example wherein an Indian entity cannot establish an Indian subsidiary by an offshore company where the Indian entity is treated as shareholders. Though the intention was to avoid the round tripping yet it was the root cause of problems for bonafide corporate structures along with flip structures. Nonetheless, the RBI removed the prohibition and amended its FAQ. It permitted the Indian companies to establish Indian subsidiaries with prior RBI's approval.

It is gratifying to note that for enabling legitimate flip structures, a High-Level Advisory Committee was formed by the Government of India under the chairmanship of Surjit Bhalla to do certain changes in the foreign investment rules. The committee suggested that the legitimate business activities could get affected by such prohibition on transfer of funds. It concluded that the investment in India under Automatic Route must be allowed through an offshore holding company having a genuine banking channel which would be based on legitimate funds. In addition to this, if there is an investment by a foreign entity wherein total FDI value does not exceed 25%, in terms of consolidated net worth, it shall not be considered as round tripping or it should not be considered like the overseas direct investment regulations has been violated. The benefits under the automatic approval are that under the automatic RBI's approval, the regulatory process could speed up in genuine cases which would be the cause of attraction for many legitimate businesses for flip structure transactions.

Hence, taking into consideration the RBI's approach, it will be crucial so far as permitting the legitimate externalization is concerned. As a part of the expert opinion, I asked Mr. Aditya Parolia, Senior Associate, who specializes in private Equity and Merger and Acquisition, said that there are some regulatory constraints for Delaware flip transaction particularly in the areas of Indian taxation laws. For instance, all are categories of the AIFs should be placed under capital gains. Bonafide business activities should be clearly defined and it should fall under automatic route.

Challenges from Indian Taxation Law Perspective

There are certain tax implications from the perspective of the Indian start-up company. Investment made in any company brings certain liabilities as well. In this regard, for bringing the functioning of the company cost-effective, externalization brings some pragmatic solution for reducing the tax liabilities. One of the main reasons for the motivation of Indian start-up companies for flipping the structure in other jurisdictions like US or Singapore are that Indian tax regime is tightly and strictly regulated. For doing business, it seems to be difficult in India for start-up companies since they have been imposed with numerous taxes at exorbitant rates, like gift tax, capital gains tax, corporate tax, angel tax, minimum alternative tax, employee stock option plan tax, etc. For instance, the imposition of corporate tax in India on domestic companies varies between 22-25% exclusive of surcharges whereas in the UK it is comparatively lower which relies on 19% approximately.

Though there has been various reforms in the Indian taxation law through Union Budget and other instruments yet compliance with taxation laws brings many hurdles so far as attracting the foreign investors are concerned. The exemption has been granted to those start-

ups which are registered with Department for Promotion of Industry and Internal Trade (DPIIT) from paying 30% angel tax which was charges under section 56 (2) (viib) of the Income Tax Act, 1961. Nonetheless, there are difficulties appeared in income tax returns because of non-resolution of angel tax related issues. The tax implications for deciding a cost-effective jurisdiction are very important for any Indian start-up companies while thinking to externalize or flip their structures. Transferring the fair market value of shares has to be taken into consideration. The income tax authority is authorized to determine the fair value as taxable irrespective of the fact whether the actual consideration is paid or not.

Under General Anti-Avoidance Rules (GAAR), it is important to take the commercial substance test into consideration. The purpose of such tax was to maintain a check on tax avoidance and to confirm that companies are taxed under appropriate tax brackets. Consequently, it becomes the root cause of imminent threat for flip structuring. A company must take into consideration rules while conducting externalization. The place of effective management test for the purpose of determination of residence of a foreign company for taxation does contain implications. The intention of enacting such laws was to bring the domestic laws in consonance with international standards and to prohibit the companies so that they could not avoid the tax liability irrespective of the fact that its management and control is performed from India itself.

For value creation and inclusive growth of business, a robust intellectual property environment for entire start-up ecosystem is important. Although the flip structuring of Indian company related to transferring of intellectual property is permitted under the FEMA, yet the issue of taxation and valuation contains certain implications. For instance, the valuation is supposed to be determined as per the fair market value price of the intellectual property. In short, the cost-effective externalization carries much more importance. The patent box regime has been provided by the Indian tax law offering the incentivized tax rate on royalty income acquired from patents developed in India.

Conclusion

It has often been opined by the experts that due to over-valued exchange rate policy, Indian exports have performed badly. In this regard, devaluation of currency could not be considered an effective option. The high cost of capital is another problem as to why Indian industry is far behind in competitive race. High level of effective corporate tax is another major hurdle for attracting the foreign investment. Numerous regulatory restrictions, onerous tax and compliance requirements would consider as major hurdles for foreign investors for not investing in India. Hence, the foreign investors are being discouraged due to high transaction costs from making direct investment in India. Apart from this, Delaware's contribution for the development of internal corporate governance mechanism is undeniable. I have already heighted the changes from the corporate governance perspective like foreign company, directors duty, compulsorily convertible debentures, private placement, exchange control, etc. I have also covered the changes from taxation perspective wherein I have argued whether such changes could be good for private equity and venture capital investment. There are many challenges as well for such investments from the regulatory and taxation perspective which I have highlighted in details. It is the need of the hour that the Indian authority should comply with the suggestions given by the High Level Advisory Group, 2019 and suggestions given by Narayan Murthy Committee's First Report on AIF Policy.

Suggestions

There is a huge potential for increasing portfolio investment in India by foreign individuals, foreign nationals and especially the NRIs. Therefore, to attract the foreign individuals for making investment via direct route in India will bring huge contribution for capital markets and it will bring growth for Mutual funds and AIFs industry. Some of the suggestions are mentioned below:

1. FDI by an overseas JV or WOS of an Indian party is not permitted under FEMA without prior approval of the RBI. Hence, the present restrictions as per the ODI Regulations should allow overseas JV or WOS of an Indian party for undertaking FDI under the automatic route. It is also suggested that the Indian party should be permitted for undertaking ODI in a structure since an existing structure will already be there. However, there are certain conditions that one is supposed to abide by. More than 25% of the consolidated net worth of a foreign entity in terms of total value wherein the ODI has been made. There should be undertaking of fresh FDI in India by entities where FDI has been made by an Indian party.
2. Since the blanket prohibition under the ambit of round tripping is affecting the bonafide business activity, it should be removed and should be placed under the automatic route.
3. A one-time disclosure scheme should be introduced by the Government of India for the purpose of declaration of undisclosed foreign income and assets and at the rate of 15% the tax should be paid on such undisclosed income.
4. The foreign individuals should be permitted to invest in Indian capital market through multi medium and small enterprise (MSME).
5. According to AIPAC recommendation, the AIF income shall be taxed under capital gains instead of business income. For increasing offshore investments in India, the foreign portfolio investment should be considered as capital gains.
6. All the three categories of AIFs should be granted the pass-through status, since attracting the private equity and venture capital investment is relied upon current regulatory and tax framework. To ensure investor protection, Alignments of interests between managers and investors could be should be handled by making robust regulatory framework. There should be an increase in the total corpus of AIF up to 25% according to the AIF Regulations or the 50% of the offshore. Above all, the AIF should be brought into a "single alternative investment fund managers regulations".

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