

Cross-Border Stock Swap: Panacea For Startup Fund Crunch?

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On the first anniversary of the startup policy, and as a possible outcome of the 2017 budget, startups were looking at the central government with hope. Startup funding has slowed down drastically, with recent reports suggesting that funding in 2016 has declined by more than 50 percent. Several well-known startups with proven business models and ideas have either folded or are declining rapidly. History has proven, time and again, that lack of funding can stymie the growth of start-ups which otherwise would have turned out as winners. In such a situation, having the ability to consolidate with other companies, by using stock as currency (i.e. stock swaps), will be a major boost for startups to salvage their business. Simply put, a stock swap is a mechanism where shares are purchased by an acquirer in consideration for other shares, instead of providing cash consideration.

Internationally, many countries have allowed stock swaps to ensure that startups and growth stage companies are able to consolidate and become profitable. However, the Indian government's efforts in this regard have not been promising, and the focus is back on the need for game-changing policy amendments to provide a fillip to the startup industry.

Regulatory Shift And Implications

In India, the government finally turned talk into action last year and partly liberalised the share swap regime by permitting cross-border primary share swaps (i.e. share swaps only involving issuance [not transfer] of shares by an Indian company, in sectors where foreign direct investment (FDI) is permitted under the automatic route). However – the key question which remains – why just the part liberalisation, despite a decade of discussion? Will this part liberalisation achieve the objective of enabling high growth trajectory for domestic companies and in-turn increase job growth?

To examine this, we need to first identify the objective – if any – of the government in restricting automatic share swaps. The earliest official discourse which contemplated permitting share swaps under the automatic route was a discussion paper released by the Department of Industrial Policy & Promotion (DIPP) in 2010. While the larger theme of the discussion paper dealt with the issuance of shares for consideration other than cash, a limited reference was made to permitting automatic share swaps in the context of overseas direct investments. There was no action undertaken by the government pursuant to this discussion paper, and share swaps continued to remain subject to the approval of the Foreign Investment Promotion Board (FIPB).

What was more striking in the discussion paper was the lack of underlying fundamental principles based on which share swaps were proposed to be permitted or restricted.

Unfortunately, this lack of clarity continues till date and as a result, any progress on this front seems devoid of direction.

For instance, take the recent attempt at liberalising share swaps. For the past two-three years, industry participants have been voicing for the complete liberalisation of cross-border share swaps, partly to encourage stock-financed inorganic growth and consequent consolidation. However, in a rather unclear move, the government has now permitted investment only by way of primary share swaps, as mentioned earlier.

While the move to liberalise share swaps is a step in the right direction, what befuddles us is the rationale for only liberalising primary share swaps and no other forms of share swaps.

Having said this, the government's main concerns, in our view, in liberalising share swaps completely – especially in the context of inbound mergers and acquisitions (M&A) – could be the following:

- reduced inflow of foreign capital due to share swap transactions; and
- the possibility of misuse of share swaps, given the extant pricing guidelines and the flexibility in valuation methodologies.

On the first issue concerning reduced capital inflow, it is important to understand that share swaps can never substitute conventional M&A transactions which involve inflow of FDI. Past literature in India suggests that share swaps are adopted mostly only in sectors which are in need of consolidation. In fact, under the existing regime, although the FIPB has been reasonably forthcoming in granting approvals for share swap transactions, such transactions have hardly impacted the inflow of FDI.

Learnings from other developed jurisdictions, like the United States, also suggests that share swap deals have often been undertaken with the intent to consolidate and benefit from post-swap synergies. Further, in cross-border inbound transactions, while FDI may be impacted in the short-term if an Indian resident is provided shares of a non-resident, the value of such shares may increase; ultimately resulting in a higher FDI inflow (at the time of sale of such shares).

On the second issue, regarding valuation methodology, it would be imprudent to suggest that there exists no risk of misuse of share swaps. There is certainly an apprehension of non-residents manipulating the valuation of shares to be issued or transferred to Indian residents, eventually resulting in a loss for the Indian resident. While this risk has to

be acknowledged, if appropriate checks and balances are incorporated (like preferred methods of valuation, defining valuation parameters etc.), prior approval of FIPB for share swaps, even in a secondary share swap scenario, can be done away with.

Tax Implications

Even if all kinds of swaps are permitted under the automatic route, it will not achieve the desired result unless the attendant tax implications are addressed. Currently, shareholders who swap their shares with the shares of another entity are taxed as if they have cashed-out (value difference between the acquired shares and sold shares is taxed).

In our view, unless this tax position is changed and stock swaps are made tax neutral, a liberalised stock swap regime would be of no benefit whatsoever. Think about this scenario – shareholders of a startup swap their shares for shares of another company (Indian or foreign) for lack of funding or for any other reason. In effect, all they have achieved is to give up one instrument (shares of their company) to get another instrument (shares of the new company). In such a situation, imposing capital gains tax on the value of the value difference between the shares as if it is a cash-out, is impractical since the swapping shareholders will have to go out of pocket in order to pay tax.

Further, conceptually, a stock swap is akin to a merger, since the shareholders continue to stay invested without realising immediate profit or returns. Hence, unless a person receives cash or liquid stock (i.e. listed stock), illiquid stock swaps should be made tax neutral and tax should be collected only at the time of cash-out by the shareholders. Other countries recognize this principle as well and do not tax a pure-play stock swap. For example, in the US, under Code 368, a stock swap also known as Type B reorganisation is considered to be tax neutral provided it meets certain conditions.

In essence, any tax implication at the stage of stock swap would adversely impact the ability of startups to implement a stock swap, thereby preventing value-accretive consolidations.

The government should also consider the fact that by permitting a tax neutral stock swap and encouraging value generating consolidations, higher taxes can be collected at a later date when the shares of the consolidated entity are disposed.

The Road Ahead

All in all, there needs to be a positive attempt at completely liberalising cross-border share swaps and providing a boost to stock backed M&A. The government should walk the talk and ensure that cash-strapped domestic companies are given an opportunity to consolidate and script a turnaround. A tax neutral automatic stock swap regime will also serve as a much-needed lifeline for many startups who are on the verge of closure due to cash crunch issues. The Indian startup space is in a state of a severe slowdown, and swift action is the need of the hour.

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