Chamber of Tax Consultants, Bangalore

Start-Up Structuring

Tax & Regulatory Aspects

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Contents

Section 1

Entity Options

Entity Options – Company vs. LLP in India

Company

- Stable and well understood form of entity
- Investors are comfortable with company
- Mature form of entity option
- Enforcement of rights and other legal aspects are settled
- Ability to enforce liquidation preference, etc..
- Almost all entities raising funds are companies

LLP

- Key advantage – No Dividend Distribution Tax
- Lower compliance hassles
- Not well understood form of entity
- Enforcement of rights and other legal aspects are yet to be settled
- Access to bank funding challenging
- FDI in LLP is permitted in sectors where 100% FDI is permitted for companies under auto route
- LLP with FDI can also make downstream investment in company / LLP

Section 2

India HQ vs. Overseas HQ

India HQ

Pros

- Most of the Promoters are likely to be Indian residents – lesser regulatory hurdles of India HQ
- Lesser challenges from a round-tripping perspective

Cons

- Comparatively higher tax costs
- Significant compliance requirements
- Weak IP protection laws
- Stringent regulatory regime
- Relatively lesser ease in doing business
- Potential discount in valuations
- Under-developed financial markets, including listing options

Overseas HQ

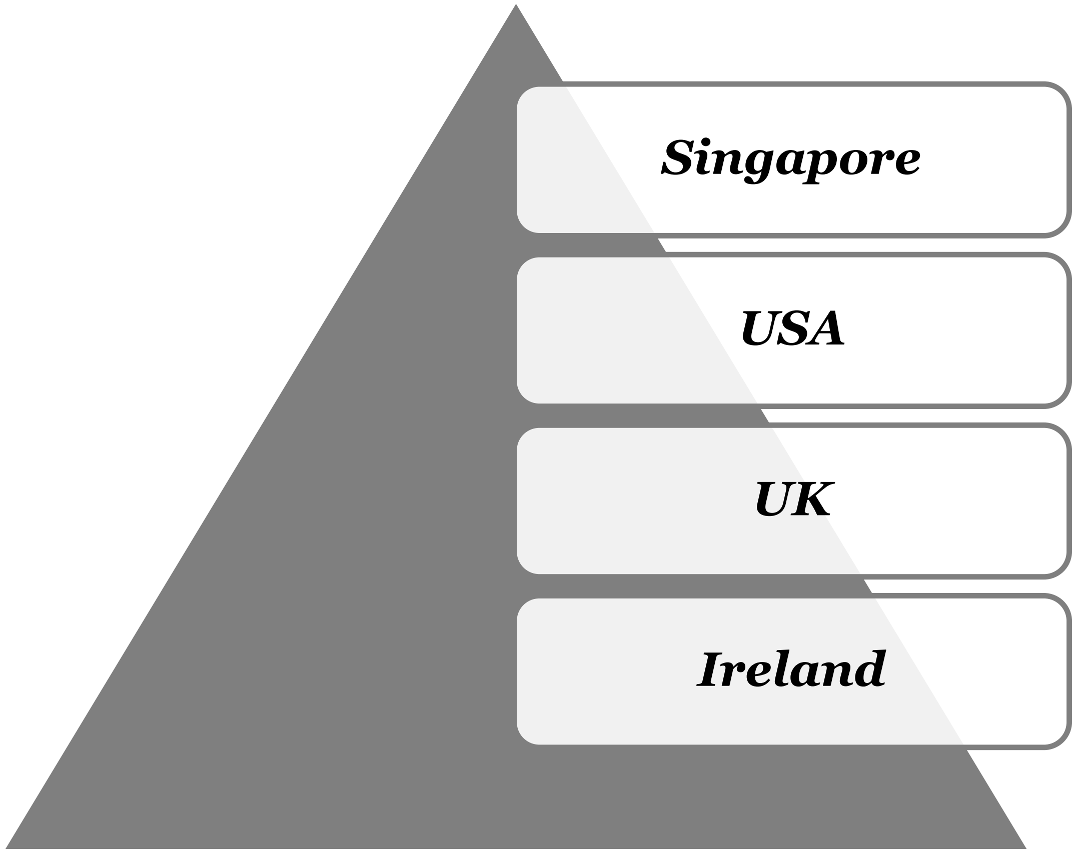
Pros

- Relatively higher ease in doing business
- Typically lower corporate taxes
- Fiscal and tax benefits can be availed
- Strong IP protection laws
- Various listing options
- Developed financial markets
- ***Relatively higher valuation***
- Favourable tax treaties with most countries

Cons

- Realignment involves additional efforts and cost
- Substance requirements to be adhered to
- Round tripping issues
- POEM risk

Key Jurisdictions



Section 3

Setting-up Overseas Structure

Overseas Investments by Individuals

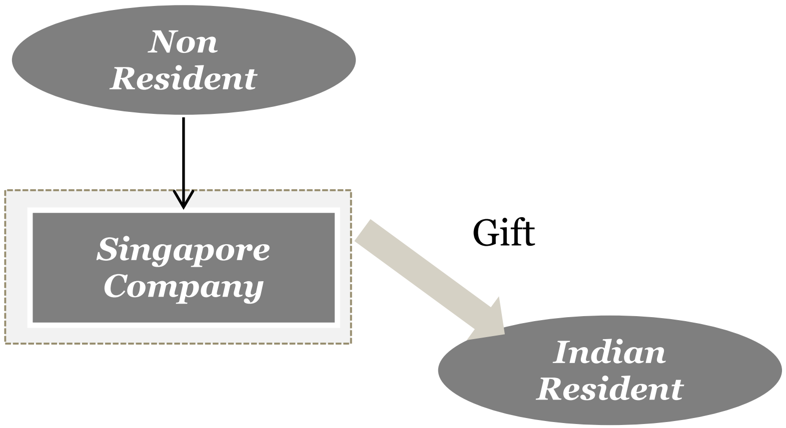
- Limit under LRS up to USD 250,000 per annum/ per person
- Possibility of pooling limits of individual family members
- Investment in unlisted companies covered under ODI Regulations
  - Investment limit flows from LRS – USD 250,000
  - Reporting requirements brought in for ODI by individuals
- ***Resident individuals cannot invest in foreign companies having downstream subsidiaries – in India or elsewhere***
- ***No restrictions on downstream subsidiaries for investments under the Portfolio Investment Route***
- ***Overseas companies having Indian resident investment should be 'single layer operating companies'***
- ***Cashless ESOPs should not be subject to restrictions under LRS***

Overseas Investments by Companies/ LLP

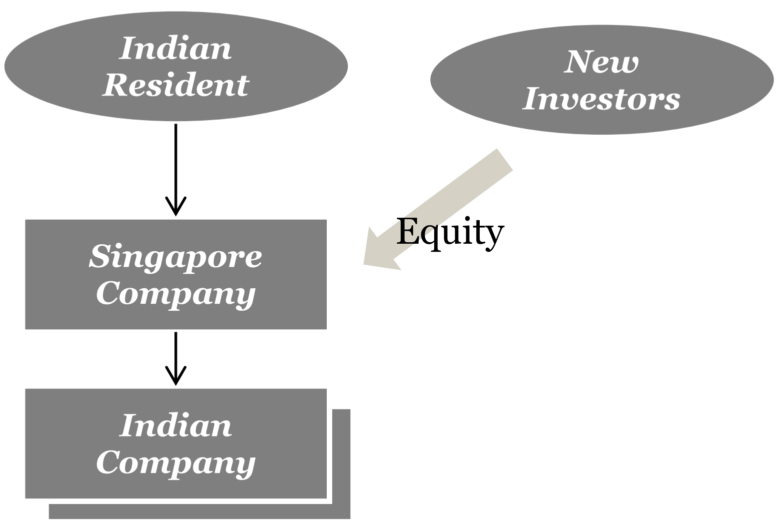
- Total financial commitment not to exceed 400% of the net worth
- Net-worth should be construed as on last audited Balance Sheet
    - Net worth means paid up capital and free reserves (including securities premium)
- Investment can be made by way of equity, preference share capital/ debt
- Investment < USD 5 mn requires valuation by a Chartered Accountant
- ***Rounding tripping concern to be borne in mind and specific approval required from the RBI***

Option 1: Gift Route

Set-up of Singapore Company & Gift



Raising Equity by Singapore Company



Key Steps

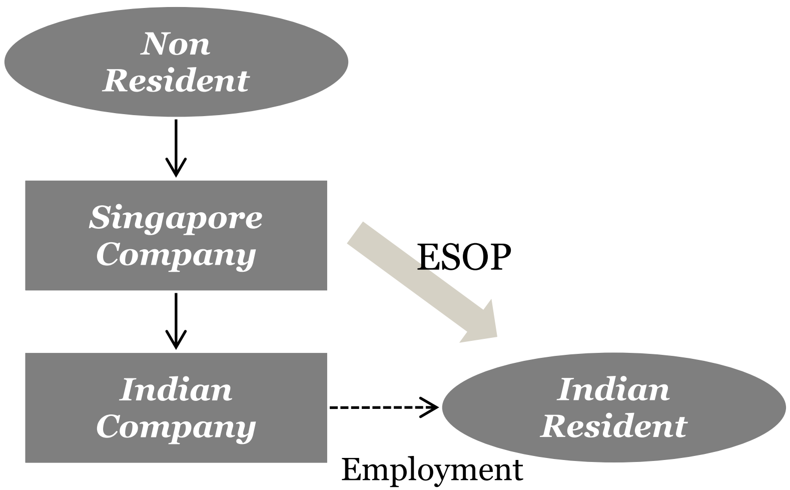
- Non Resident (relative) to incorporate Singapore Company, with say USD 10,000
- Non Resident (relative) to gift shares in Singapore Company to Indian Resident
- Investors to be roped into Singapore Company
- Singapore Company to acquire stake in Indian companies

Key Implications

- No tax implications on gift of shares between specified relatives
- Acquisition of shares in Singapore Company through gift from non-residents permitted under FEMA
- Acquisition of shares in Indian companies by Singapore Company to be at fair value
- Greyness of the gift structure

Option 2: ESOP Route

Set-up of Singapore Company & Indian Company



Phase I: Setting-up of the Structure

Key Steps

- Non Residents to incorporate Singapore Company, with say USD 10,000
- Singapore Company to incorporate an Indian company
- Indian Resident to be employed with Indian company
- Singapore Company to grant ESOP/ sweat equity to Indian Resident

Key Implications

- Acquisition of shares in through ESOP in Singapore Company permitted under FEMA
- ESOPs should be on cashless exercise basis
- Fair value of ESOP liable to tax in India

Phase II: Roping in of New Investors

- Similar to Option I

Option 3: RBI Approval

- Approval of the RBI to be obtained for ODI/ FDI structure
- Typical timelines: 6-9 months

Migrating Indian Business

Option 1: Share Swap Arrangement

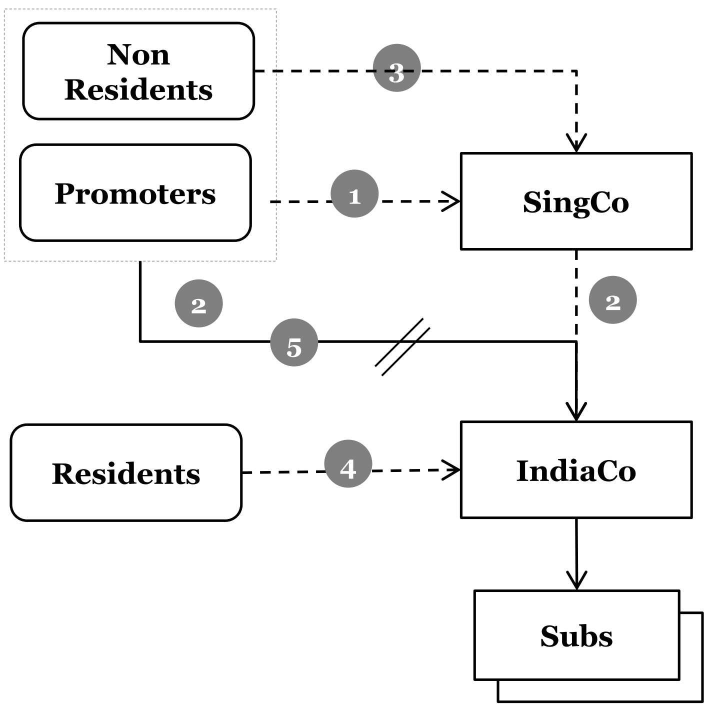
Option 2: Asset Sale/ Slump Sale

Option 3: Demerger

Option 4: Merger

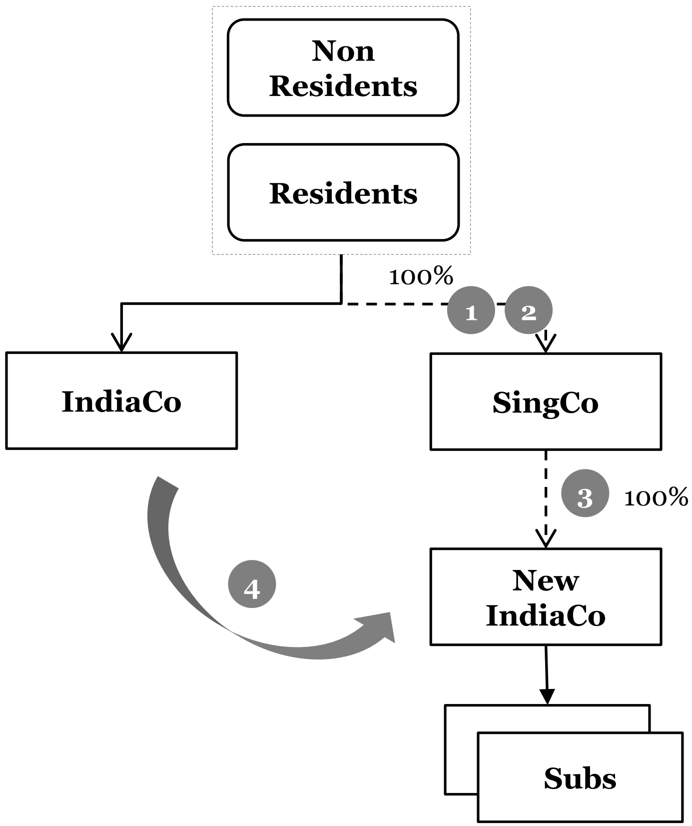
Option 5: Cross Border Merger

Option 1: Share Swap Arrangement



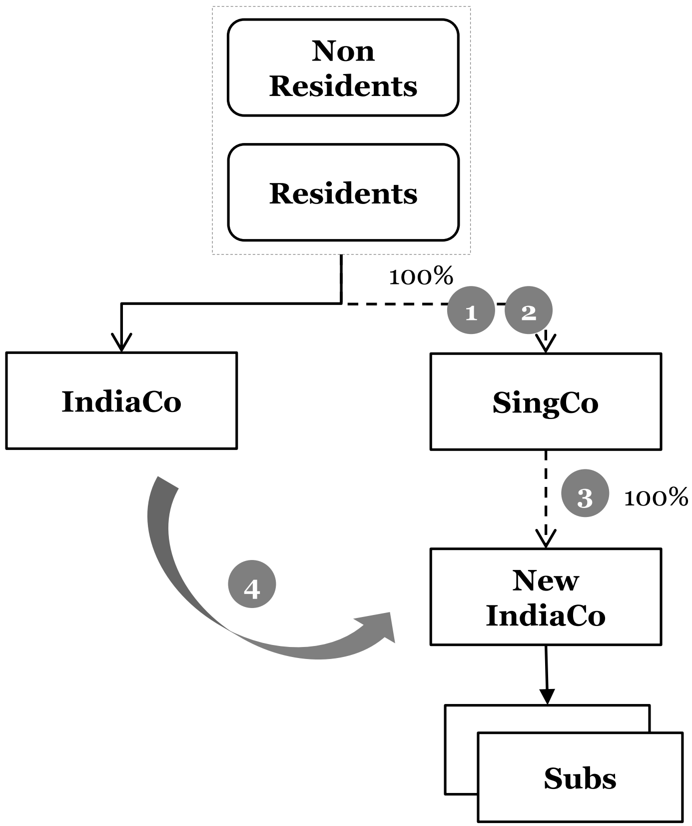
- ***Step 1:*** Promoters to set-up a company in Singapore (SingCo)
- ***Step 2***: SingCo to acquire NR Shareholders stake in IndiaCo
- ***Step 3***: SingCo to issue its shares, as consideration for Step 2
- ***Step 4***: Resident Shareholders to enter into an Option Agreement
- ***Step 5***: Capital reduction/ buy-back of shares held by Promoters in IndiaCo

Option 2: Asset Sale/ Slump Sale



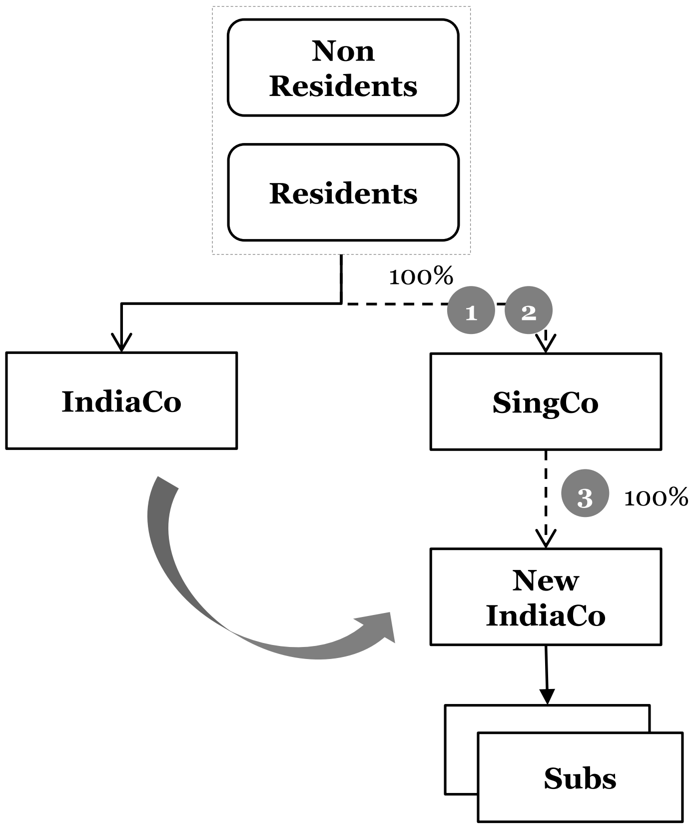
- ***Step 1:*** Promoters to set-up a company in Singapore (SingCo)
- ***Step 2***: Non resident investors to invest into SingCo
- ***Step 3:*** SingCo to set-up a wholly owned subsidiary in India (say New IndiaCo)
- ***Step 4***: IndiaCo to sell identified assets to IndiaCo through an asset sale agreement

Option 3: Merger/ Demerger



- ***Step 1:*** Promoters to set-up a company in Singapore (SingCo)
- ***Step 2***: Non resident investors to invest into SingCo
- ***Step 3:*** SingCo to set-up a wholly owned subsidiary in India (say New IndiaCo)
- ***Step 4***: IndiaCo to merge/ demerge its business into New IndiaCo, through a Scheme of Arrangement

Option 4: Cross Border Merger



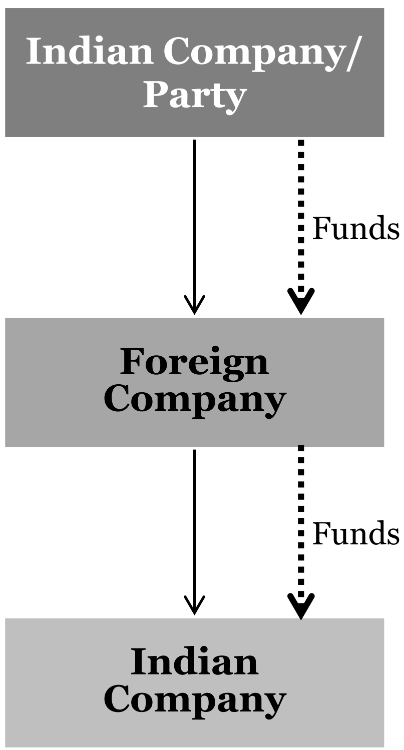
- ***Step 1:*** Non Resident shareholders to set-up a company in Singapore (SingCo)
- ***Step 2***: IndiaCo to incorporate a new subsidiary in India (New IndiaCo)
- ***Step 3:*** IndiaCo, SingCo and New IndiaCo to enter into a Scheme of Arrangement
  - IndiaCo shall transfer its entire business to New IndiaCo on a Slump Sale basis
  - IndiaCo shall be merged into SingCo
  - Scheme to be approved by National Company Law Tribunal

Section 4

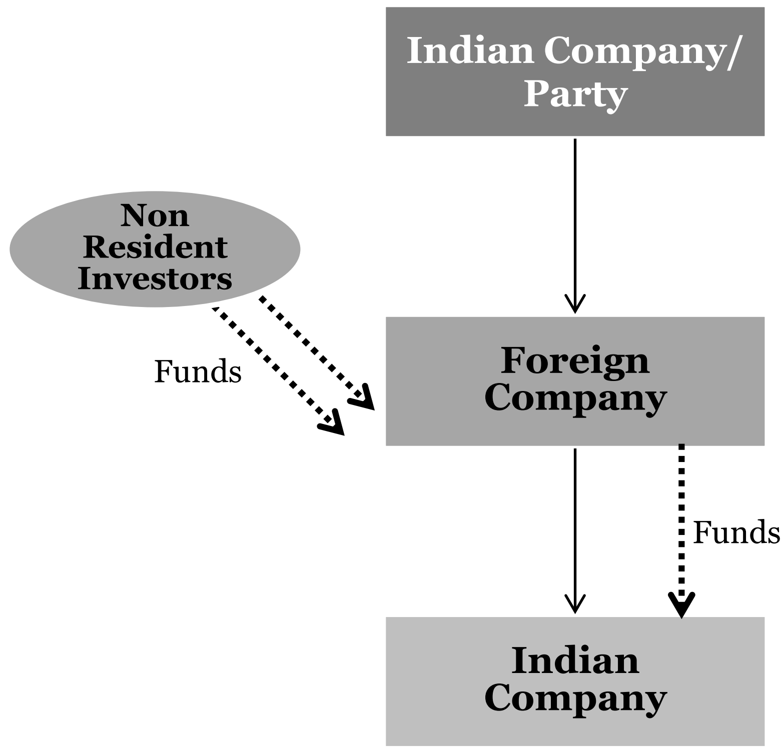
Round Tripping Issues

Round Tripping – Meaning

View I – Round Tripping of Funds



View II – Round Tripping of Structure



Round Tripping – Likely Challenges

ODI Regulations

- ODI for bonafide business activities
- Financial services not permitted

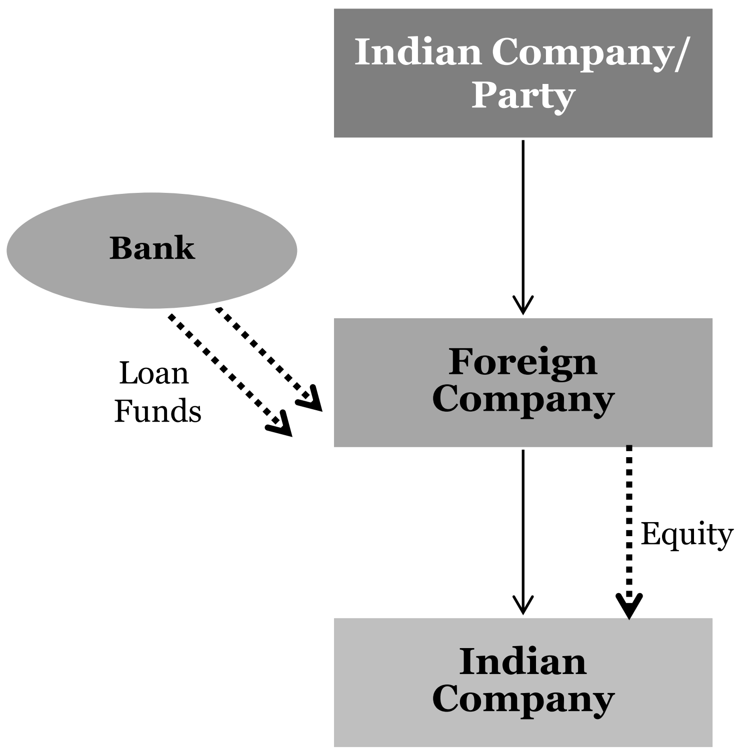
ECB Regulations

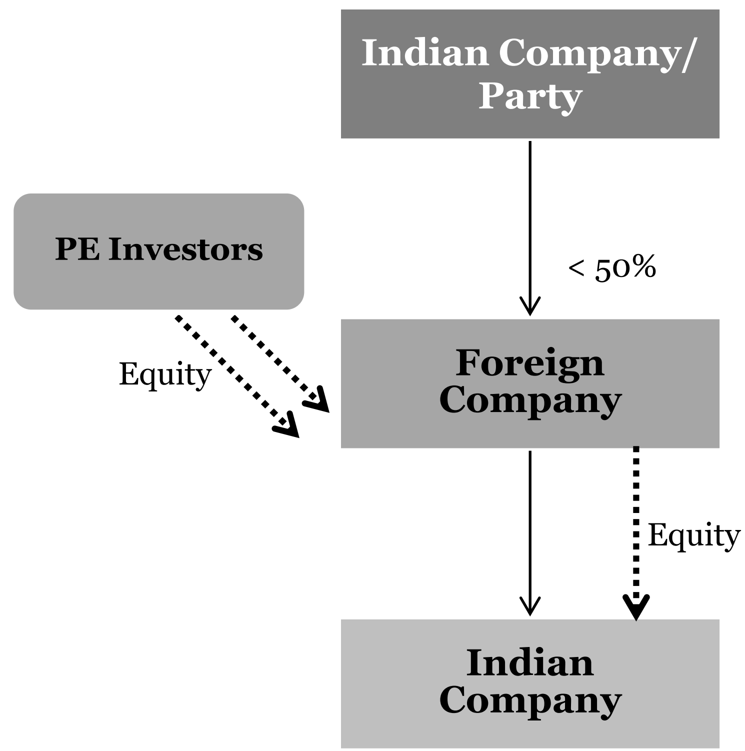
- Leveraging overseas for investment into India could amount to Deemed ECB
- End-use restrictions can be violated

FDI Regulations

- Not genuine foreign investor
- Debt funds could be rerouted into India

Round Tripping – Illustrations





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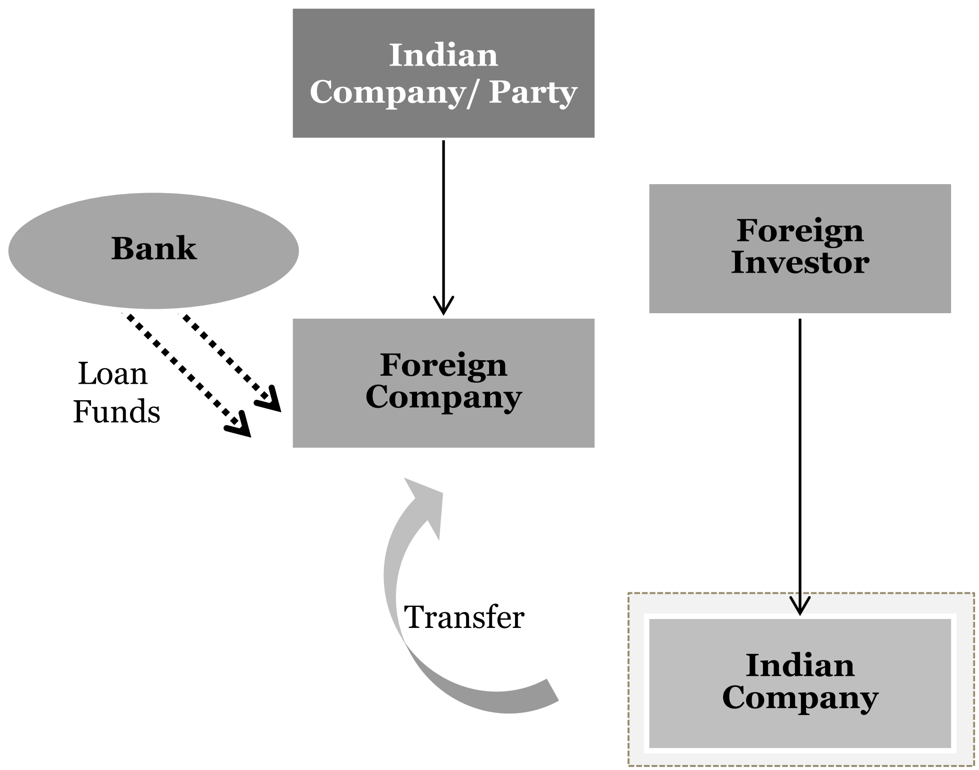
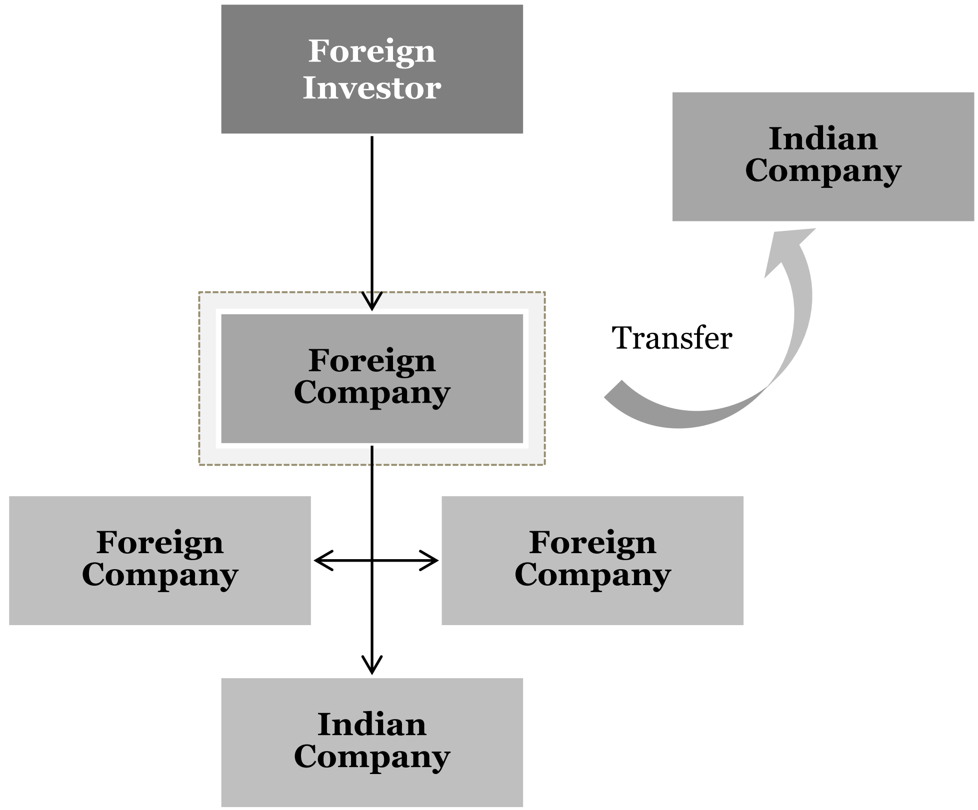


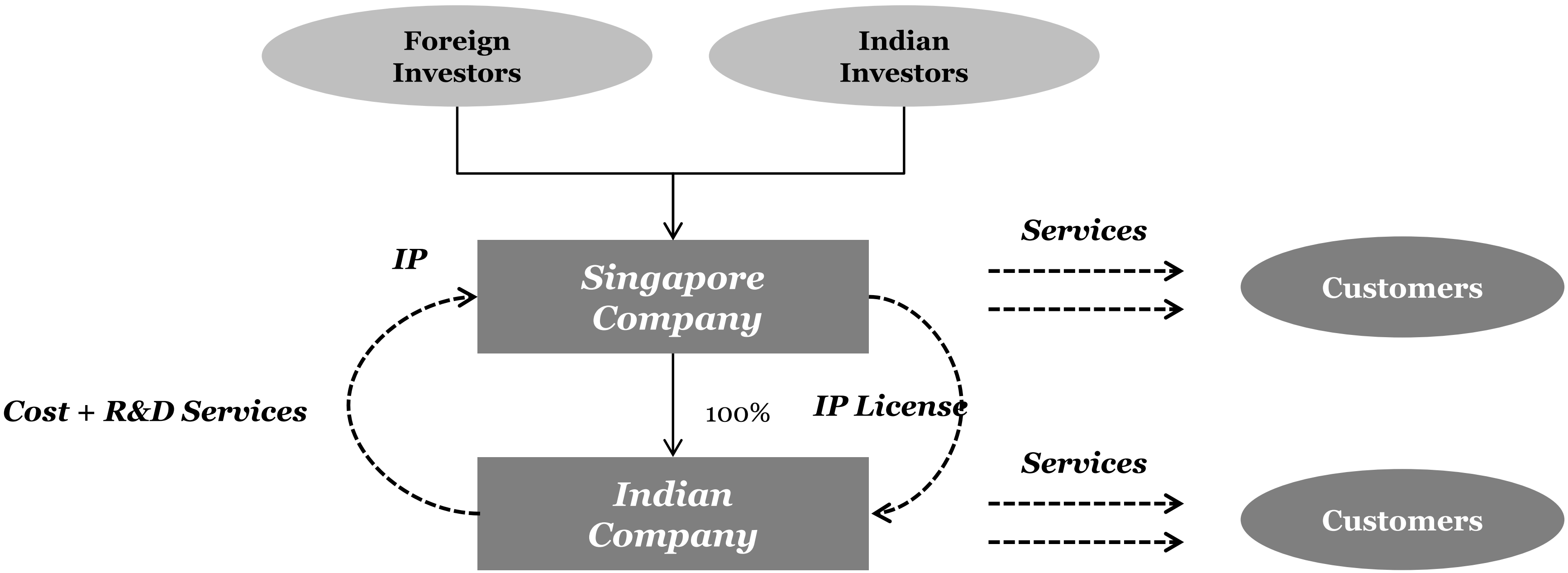
Round Tripping – Illustrations



Section 5

Business Models

IT Product Companies



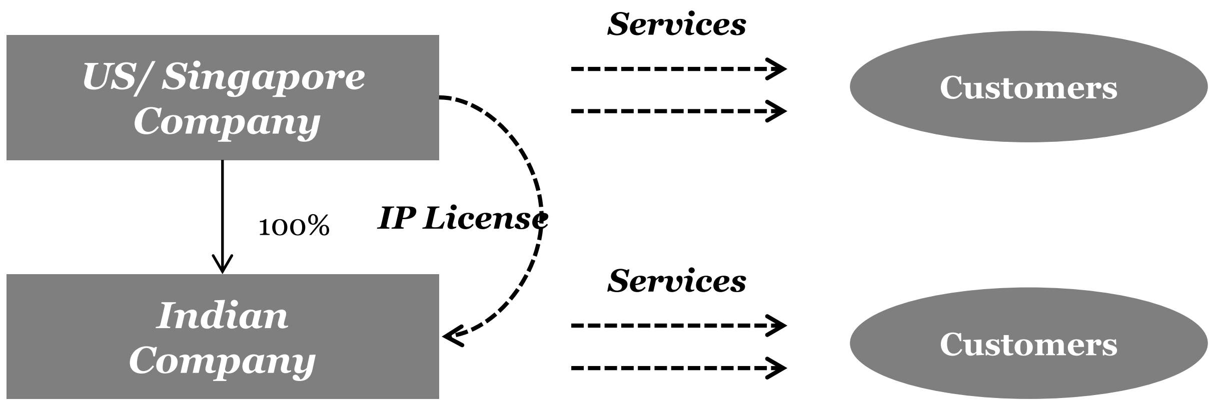
Cost + R&D Services

- Cost + 16% to 18%
- Directions for developing IP to come from Sing Co
- Indian Co is a limited risk entity

IP License

- 'Stop loss' arrangement can be put in place
- No royalty payable by Indian Co, until it turns profitable
- 3-4 year moratorium possible

Contracting Structure

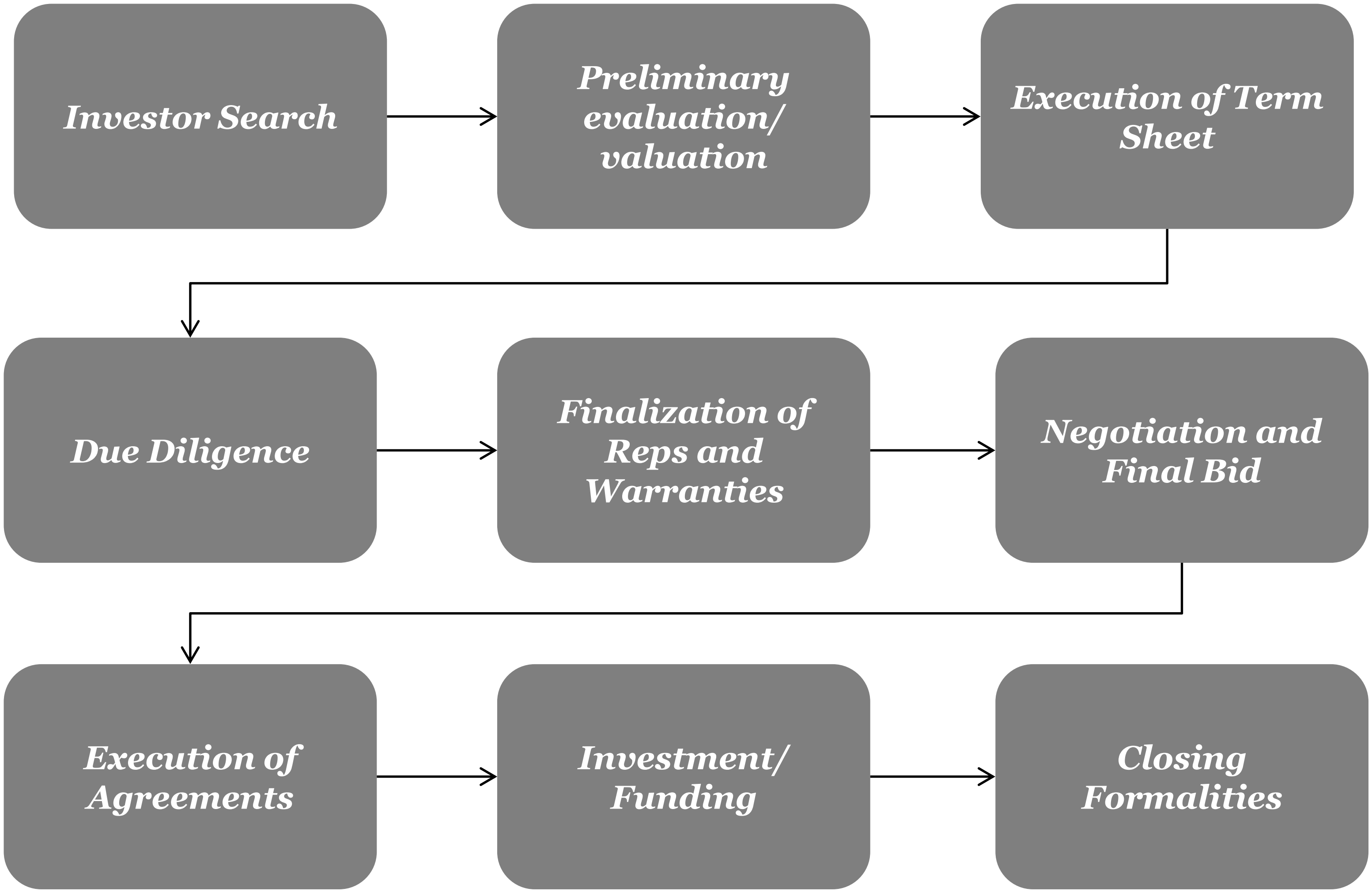


- OverseasCo shall contract with overseas customers
- IndiaCo can contract with India customers
- IndiaCo can be reseller or function as a full fledged entity
- IndiaCo to pay license fees/ royalty for use of IP belonging to Overseas Co

Section 6

Fund Raise Cycle & Typical Issues in Start-ups

Fund raise process



Legal Documentation in Start Ups

- ***Confidentiality & Non-disclosure Agreement***
- ***Non-Competition & Non-Solicitation Agreement***
- ***Intellectual Property Assignment Agreement***
- ***ESOP Scheme***
- ***Term Sheet/ LOI/ MOU***
- ***Share Subscription Agreement***
- ***Shareholders' Agreement***

Rights typically given to Investors

Pre-emptive	• Right to be offered shares, prior to any other party
Right of First Refusal	• Promoter intending to sell, to first offer the investor
Tag Along Right	• Investor's right to sell to promoters' buyer on same terms
Drag Along Right	• Right to have promoters sell to the Investor's buyer
Put & Call Options	• Investor's right to sell shares held by him and right to buy shares held by others
Liquidation Preference	• Investor receives priority in an exit scenarios
Affirmative Rights	• Investor's right to block certain resolutions at board/ shareholders levels
Anti-dilution Rights	• Protects value of investor's shares, when company issues fresh shares @ lower price

Promoter Clawback Options

- Stock Appreciation Rights (SAR)
- Private Placement to Promoters of Warrants
- Right's issue Par value/ Net-worth
- Optionally Convertible Preference Shares
- Selective issue of Bonus shares
- Amendment of conversion ratio of Investors

Other Issues

- Allotment of different investors at different prices
- Angel/ Super Premium Tax
- Valuation for Allotment of Shares
- Convertible Notes: Instrument & Treatment
- Parallel Allotments
- Reverse Vesting and its implementation
- Cofounder Issues & Exit
- Pricing Adjustments

Section 7

Employee Incentive Plans – Types

Employee Incentive Plans

Employee Incentive Plans

- ***Equity Settled***
  - *Employee Stock Option Plan (ESOP)*
  - *Employee Stock Purchase Plan (ESPP)*
  - *Sweat Equity Shares*
  - *Restricted Stock Units (RSU)*
- ***Cash Settled***
  - *Phantom Stock*
  - *Stock Appreciation Rights (SAR)*
  - *Cash Bonus*

Employee Incentive Plans

Employee Stock Option Plan (ESOP)

- Employees are Granted Options, which shall be Exercisable into equity shares upon Vesting
- Vesting typically over 3/ 4 years
- Minimum vesting period: 1 year
- ESOP is an incentive to perform in future
- Annual grants vs. one time grants can be considered

Employee Stock Purchase Plan (ESPP)

- Equity shares allotted upfront, typically in reward of past performance
- Shares so allotted subject to lock-in requirements – 3 years under Companies Act, 2013

Restricted Stock Units (RSU)

- Similar to ESPP
- Terminology used in the West
- Typically listed shares are acquired from the market towards this

Employee Incentive Plans

Phantom Stock

- Value is linked to actual shares
- Economic implications similar to allotment of equity shares
- Cash settled at the end of the specified period and is linked to value of shares
- Typically, no dividend is paid
- Needs to be adjusted for bonus, stock splits, etc.

Stock Appreciation Rights (SAR)

- Very similar to Phantom Stock
- A base price is agreed upon and only appreciation in value is paid out in cash
- In case of Phantom Stock, no base price is set
- Few plans provide for equity settlement of the difference as well
- Typically, no dividend is paid
- Needs to be adjusted for bonus, stock splits, etc.

Employee Incentive Plans

Cash Bonus

- Cash Bonus can be paid, where quantum and payout is linked to performance or retention
- Typically, senior management is covered under such incentive plan

Section 9

Employee Stock Option Plan (ESOP)

Designing ESOP Scheme: Key Parameters

Particulars	Explanation
Size of the Pool	• The maximum number of options that are proposed to be issued to employees (collectively) immediately and in future to be determined • Entire pool can be utilized at the time of initial grant or some portion can be retained for future grants
Eligibility Criteria	• Parameters that can be considered – length of service, designation, performance, contribution for growth in past, future contribution potential, etc. • The eligibility criteria can be defined in the ESOP plan or defined by the Board of Directors subsequently
Grant of Options	• Grant refers to issuing options to employees, which would entail them to subscribe to shares in future, subject to satisfaction of conditions • The ESOP Plan can provide for maximum number of options that can be issued to an employee - no specific restrictions under the law
Authority to Grant Options	• Board of Trustees • Board of Directors • Compensation Committee (N&R Committee)

Designing ESOP Scheme: Key Parameters

Particulars	Explanation
Vesting Criteria	• One Time Vesting • Annual Vesting • Cliff & Monthly/ Quarterly Vesting • Performance linked vesting • Retention linked vesting
Exercise Price	• Price payable towards allotment of shares under ESOP • Lower the exercise price – higher the chances of exercise by employees and higher the benefit to employees • Can be kept at a minimum, i.e. at face value • Possible to have Nil exercise price
Lock-in-period	• Restriction period for transfer of shares, after exercise • Ensures continuous participation of the employees in the growth of the company • Not mandatory under SEBI Regulations/ Companies Act • No restriction on lock-in period

Designing ESOP Scheme: Key Parameters

Particulars	Explanation

Exercise of Options	• No minimum/ maximum time frame for exercise is prescribed
	• Exercise can be anytime after vesting or during a liquidity event
	• Liquidity events mean public offering, strategic sale, consolidation or merger, fund raise of specific amount, transfer of control, etc.
	• Pros of exercise during Liquidity Event:
	  • Minimum number of shareholders on the capital table
	  • Eliminates the hassle of executing shareholders agreement, compliances, etc
	  • Deferral of tax until liquidity
	• Cons of exercise during Liquidity Event:
	  • Higher tax incidence, as entire income will be salary income
	  • Arbitrage in relation to lower capital gains tax rate or exemption cannot be availed

Other Aspects	• Tag along/ drag along rights • Buy-back of shares • Power of attorney for exercising rights on behalf of employees • Accelerated vesting on change in control, management discretion, etc. • Right of first refusal, if an employee wants to sell his shares

Designing ESOP Scheme: Key Parameters

Particulars	Explanation
Exit Options	***Scenario 1: IPO Listing*** • Shares allotted through ESOP can be sold on the stock exchange • Capital gains exemption can be claimed based on period of holding
	Scenario 2: Company is not listed • Employees to exercise the shares and sell to willing buyers • Alternately, employees can be compensated in cash, in lieu of shares that are to be allotted – Phantom Stock • Shares can be bought-back from the employees at fair value • Independent valuation can be undertaken for ascertaining the fair value

ESOP: Tax Implications – Employees

On Grant/ Vesting of Stock Options

- No tax incidence

On Exercise of Stock Options

- The perquisite shall be subject to tax as 'Income from Salary' @ 30% ++ (depending on the total income of the employees)
- Employment location during the vesting period relevant for ascertaining taxability in India
- Perquisite would be taxable in hands of employees in India on a proportionate basis, if they have been partly resident and otherwise during the vesting period (Robert Arthur Keltz – Delhi ITAT)
- The taxability in the hands of non-resident employees would also be subject to the applicable tax treaty
- Exercise of shares in an Indian company should not be considered as received in India
  - Challenges of received in India on receipt of shares in an Indian demat account
- Section 56(2)(x) Implications
  - No 'Other Income' implications in hands of employees on receipt of shares from the company/ Trust
  - Employee pays tax on the perquisite
  - The same income should not be taxed twice under different heads

ESOP: Tax Implications – Employees

On Eventual Sale of Shares

- Gains arising on sale of shares received pursuant to ESOP taxable as capital gains
- Cost of acquisition of shares pursuant to ESOP = Fair market value of shares determined for computing tax on perquisite
- Period of holding of shares received by employees shall be reckoned from Exercise Date
  - Vesting period or period of post vesting not relevant
  - ***Sale of shares through Offer for Sale on listing: 24 months for qualifying as long term (not 12 months)***
- Resident (pre listing): 20%/ 30% ++ (depending on period of holding)
- Non-resident (pre listing): 10%/30% ++ (depending on period of holding), subject to applicable tax treaty
- Long term capital gains (sale of share post listing): Exempt/ 15%, on stock exchange sale

Thank You

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