

Chapter 1

SPAC: India tax and regulatory conundrum

This article aims to:

Discuss the Indian tax and regulatory landscape along with the challenges in a SPAC transaction.



Introduction

In our previous editions, we touched upon SPAC¹ as a lucrative model for raising capital and going public globally, accounting nuances of a SPAC transaction and financial reporting complexities involved in SPAC transactions. Continuing our discussion, in this edition, we will be discussing the Indian tax and regulatory landscape in the SPAC arena.

Inspired by the remarkable success enjoyed by SPAC transactions in the US, SPAC is also emerging as an interesting concept in the India start-up eco-system. While SPAC as a capital pooling vehicle provides tremendous opportunities for Indian unicorns to directly access global capital markets, the Indian tax and regulatory framework is not fully prepared to facilitate a smooth SPAC transaction.

Regulatory hurdles in a SPAC transaction

- **Absence of a formal SPAC regime:** Indian capital markets and corporate law currently do not have an identified regime for formation and listing of SPACs. Further, Indian companies are not permitted to directly list on overseas stock exchanges. While the government showed an intent to address this issue through an amendment of Section 23 of the Companies Act, 2013 which permitted public companies to list a class of securities on permitted stock exchanges in permissible foreign jurisdictions, corresponding enabling provisions are yet to be notified under the Securities and Exchange Board of India (SEBI), Foreign Exchange Management Act (FEMA) and income-tax laws.
 - As a step forward in this direction, a Consultation Paper was released by the International Financial Services Centers Authority (IFSCA) to establish a framework for listing of SPAC on IFSC at GIFT City, Gujarat. The key features of the consultation paper are as follows:
 - **Eligibility of SPAC to raise capital in an IPO²:** The primary objective of the issuer shall be to effect a merger or amalgamation or acquisition of shares or assets of a company having business operations and the issuer does not have any operating business.
- **Minimum offer size:** Offer size shall not be less than USD50 million and the sponsor shall hold at least 20 per cent of the post issue paid-up capital.
 - **Minimum application size:** The minimum application size in an IPO of SPAC shall be USD250,000.
 - **Minimum subscription:** At least 75 per cent of the offer size.
 - **Sponsor restriction:** Sponsor shall not transfer any of his specified securities prior to the completion of a business acquisition.
 - **Round tripping concerns under the Exchange Control Regulations:** Feasibility of cross border SPAC transactions is significantly impacted owing to lack of clarity of the FEMA regulations on cross border mergers and ability of Indian resident shareholders to hold shares of foreign holding companies which in turn hold shares in the target company. Currently, such structures are viewed adversely by the authorities and approval is granted only on a case specific basis. However, recently the government released draft Foreign Exchange Management (Non-debt Instruments - Overseas Investment) Rules, 2021 and draft Foreign Exchange Management (Overseas Investment) Regulations, 2021 which seem to ease norms around round tripping. As per the draft regulations, only those round-trip structures will be prohibited which is designed for the purpose of tax evasion or tax avoidance.

1. Special Purpose Acquisition Company

2. Initial Public Offer



- **Concerns around applicability of Press Note 3:**

Note 3: Press Note 3 of 2020 dated 17 April 2020 was introduced by the government to monitor cases of fresh investment by India's neighbouring countries. The amendment mandates a specific government approval where the transaction results in direct/indirect acquisition of beneficial ownership in an Indian company by residents of neighbouring countries which share a land border with India. An unintended consequence of the amendment hinders SPAC transactions as SPAC transactions generally require swap of India target company shares by existing shareholders against fresh shares issuance in the SPAC vehicle. Such swap of shares tends to get covered by the wide sweeping language of Press Note 3. Accordingly, evaluating the profile of the investors of the Indian target company acts as a major checkpoint prior to executing a SPAC transaction.

In the ensuing paragraphs, we will discuss the tax challenges in a SPAC transaction under Indian tax laws.

Tax hurdles in a SPAC transaction

- **Externalisation is taxable:** SPAC transactions are generally implemented either through merger of identified target companies with SPAC or through swap of shareholding of target company against shares of SPAC. Owing to the regulatory hurdles associated with cross border mergers as discussed above, SPAC transactions with respect to Indian targets are largely achieved through the swap structure.

3. Employee Stock Option Plans

Such share swaps attract capital gains tax for both resident and non-resident shareholders of the Indian target. Capital gains on the swap are computed basis the difference between the fair market value of the SPAC shares received and the cost of acquisition of shares of the Indian target company.

Capital gains tax rates may range from 10 to 40 per cent plus applicable surcharge and cess depending upon the category of the taxpayer viz individuals or company, residential status of shareholders, period of holding of shares, etc. However, in some cases the non-residents may be able to avail benefit of exemption available under the tax treaties where the investors are residents of tax favorable jurisdictions. Availability of such benefit is again dependent upon satisfaction of substance and beneficial ownership tests.

- **Overseas foreign mergers and outbound mergers are taxable:** The Indian tax law provides tax exemptions to amalgamating companies and their shareholders where the amalgamated company is an Indian company. However, the same benefit is not extended in case of outbound merger where the amalgamated company is a foreign company. Additionally, there is lack of clarity on whether shareholders of a foreign holding company of an Indian target will be eligible for tax exemptions where such foreign holding company merges with a SPAC.

- **Impact on tax losses of an Indian target:**

The Indian tax law restricts the ability of an unlisted company to carry forward its tax losses where its beneficial shareholding changes by more than 49 per cent. The Indian judiciary has divided views on whether one needs to test the registered shareholding or the ultimate beneficial shareholding for the applicability of provisions which restrict the carry forward of losses owing to change in shareholding. This acts as major dampener towards the viability of SPAC transactions considering most of the Indian targets have significant amount of brought forward losses owing to the cash burn in the initial years of their formation.

- **Swap of ESOPs are taxable:** Many of the new age Indian start-ups offer lucrative stock option plan to attract and retain talent. A SPAC transaction would typically involve such employees to swap their ESOPs³ in the Indian target company/foreign holding company against shares of the SPAC. Swap of such ESOPs does not enjoy any tax exemption under the Indian tax laws and thus, exposes the employees to unwarranted tax liability in the absence of an actual liquidity event.

- **Post SPAC transaction:** Indian tax laws levy tax on transfer of shares of an overseas holding company where such holding company derives more than 50 per cent value from Indian assets. Accordingly, all subsequent transactions involving transfer of SPAC shares are subject to the indirect transfer taxes as SPAC would derive

almost all its value from India. However, the law makers provide for a specific exemption to small shareholders holding less than five per cent of the voting power or share capital in the overseas holding company.

Way forward

While one awaits significant changes to the Indian tax and regulatory framework, SPAC-led transactions are set to dominate headlines in the coming future. Expect several unicorns and emerging companies to dominate merger transactions with SPACs.

