The IPO Prep Pipeline: Crucial Factors for Listing

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Exciting debuts on Dalal Street have kept India’s financial sector buzzing over the past decade. In fact, during this period, India's financial sector has seen a remarkable growth, with Initial Public Offerings (IPOs) serving as a key catalyst. As more firms opt to go public, the need for an optimum pre-IPO group structure, understanding key value drivers, and comprehending the tax considerations of IPOs become crucial for the companies and investors.

Those who plan, prosper

Pre-IPO planning is crucial for optimizing tax outcome, ensuring regulatory compliance, managing risks, and identifying essential value drivers. For a company to be ‘IPO ready’, the stakeholders including the company’s management and the underwriters must be aligned on the necessary corporate actions such as conversion to public company, modifying constitutional documents, dematerialization of shares, increase in authorized share capital, identification of the promoter and promoter group in a promoter-led company, finalization of the board composition, appointment of intermediaries, determination of the offer size, offer structure and objects of the offer and restatement of the relevant financial statements. Few key considerations and their ramifications are elaborated below:

- *Place of listing*: Before listing, a company must decide whether to list in India, GIFT City, or overseas, as each location has distinct regulatory frameworks - SEBI governs Indian listings, IFSCA oversees GIFT City, and foreign listings follow the regulations of the respective jurisdictions. The choice of listing location impacts eligibility, disclosure requirements, and compliance obligations, while tax implications in both the listing country and India must also be carefully assessed. Although Indian companies once explored overseas listings, the trend is reversing, with many now relocating back to India through a 'reverse flip' (such as by way of a merger or share swap), a process that requires careful planning to mitigate tax and legal consequences. The tax considerations on listing are covered subsequently. Based on the upside expected, the company to decide the location and the manner of listing in the stock markets.
- *Levels of shareholding structure*: The effective post-tax returns for shareholders under an OFS hinge on the holding structure of the company slated for listing. For example, tax on OFS may be twofold where the shareholder tendering shares is a corporate entity—first, tax on capital gains in the hands of the corporate shareholder, and second, taxation as dividends in the hands of the shareholders of such a corporate entity on the onward distribution of sale proceeds. Hence, setting up an optimal holding structure prior to listing is essential.
- *Succession planning and family arrangements*: Promoters often prefer to establish trusts to hold equity shares since they facilitate consolidation of shareholding enabling promoters to maintain control, ensure seamless management, and simplify the process of wealth distribution among heirs or beneficiaries.

The timing of trust formation is critical, as establishing trusts after listing may be subject to regulatory approvals and/or conditions. Further, any shares transferred to a trust, less than a year prior to filing of the draft offer document may be ineligible for minimum promoters' contribution, that is 20% of the post IPO paid-up share capital of the company which is mandatorily locked-in for a period of three years post allotment of share. In the event that the trust is classified as a promoter, the recent view of the stock exchanges is that the trustee of the promoter trust must also be classified as a promoter and companies should be mindful of this fact.

Further, in general, settlement of assets into the trust for family members and distribution of assets from the trust is tax efficient and taxation of income earned by the trusts is akin to that of an individual, with further distribution of proceeds to trust beneficiaries not being taxable. Additionally, trusts are also known for mitigating the impact of estate duty, should it be reintroduced in India. Hence, holding equity shares through a trust structure may also be explored.

- *Intellectual Property (IP)*: Strong IP assets, like patents, trademarks, and copyrights, held by the corporate group, need to be evaluated for their effect on the overall IPO valuation and potential need for IP transfer. This process should carefully consider the accurate capture of the IP's value and tax implications. The IP which is material to the company may warrant disclosures in the offer documents.
- *Split / bonus prior to IPO*: Companies often resort to share splits or bonus issues before an IPO to render the share price appealing to investors. Share splits reduce the price per share while a bonus issue increases the number of circulating shares without additional shareholder investment, affecting the overall share value. In a stock split, from an income-tax standpoint. the share cost is typically calculated by dividing the original cost by the total post-split shares, despite no explicit provision. For bonus shares, the cost basis is zero. When calculating capital gains, despite no explicit provision, the acquisition date for split shares is arguably the same as the original shares, while for bonus shares, it is the allotment date.

Given the complexities of equity structures, deciding on a split or bonus issue before an IPO can be pivotal given the unique tax implications.

- *Capitalization table prior to IPO*:

Equity shares are required to be fully paid-up and held by the selling shareholder for a minimum period of one year prior to filing the draft offer document for OFS. Further, as per SEBI's ICDR Regulations, a company shall be ineligible for an IPO if there are outstanding convertible securities or rights which entitle any person to receive equity shares, with certain exemptions. One of the conditions for an OFS is that if the equity shares are arising out of conversion or exchange of fully paid-up compulsorily convertible securities then such paid-up compulsorily convertible securities must be held by the sellers for a period of at least one year prior to the filing of the draft offer document. Properly planning the timing and structure of conversion is crucial to optimize tax outcomes and manage potential dilution.

If the company does not meet the IPO eligibility of a profitability track record and is required to make the public issue under Regulation 6(2) of the SEBI ICDR Regulations, certain additional requirements for OFS are applicable.

The Tax Angle

- *Tax rates on capital gains*: Gains on sale of shares are either taxed as capital gains (if shares were held as capital asset) or as business income (if shares held as stock-in-trade). Taxation of capital gains is dependent on (i) type of shares (ie listed / unlisted) at the time of sale; (ii) its period of holding (ie long term / short term); and (iii) whether the shares are sold off market or on market. The latest Budget has revamped the capital gains taxation regime related to sale of shares including simplification of the tax rates, rationalising period of holding, removal of indexation benefit etc. The key tax rates in multiple scenarios are mentioned in the table below. Please note, applicable surcharge and cess are to be added to these rates.

Sr. No.	Nature	Period of holding to qualify as long-term	Securities Transaction Tax	Tax rate for residents/non-residents	
				Long-term	**Short-term**
1.	Unlisted equity shares sold prior to an IPO / outside IPO ie a secondary transfer	More than 24 months	NA	12.5%	30% for individuals/LLPs/Firm/AOPs/Trust/FPIs/NRIs / 35% for foreign companies/ 22%-30% for domestic companies as per applicable corporate tax rate
2.	Unlisted equity shares sold in Offer for sale (OFS) in an IPO (ie, exit at the time of IPO)	More than 24 months	0.2%	12.5% on gains in excess of INR 0.125 million	20%
3.	Listed equity shares transferred on the floor of the stock exchange (including bulk/block deal)	More than 12 months	0.1%	12.5% on gains in excess of INR 0.125 million	20%
4.	Listed equity shares sold post IPO – off market	More than 12 months	NA	12.5%	30% for (individuals/LLPs/Firm/AOPs/Trust/FPIs/NRIs)/ 35% for foreign companies/ 22%-30% for domestic

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				Long-term	Short-term
					companies as per applicable corporate tax rate

Individuals and HUFs may seek relief from long-term capital gains tax by investing in immovable property. Non-resident investors may claim treaty benefits on capital gains as well, depending on the relevant treaty provisions.

The gap between the tax rates for long-term and short-term capital gains has widened post the Budget and is expected to incentivize investors to hold onto their investments for a long-term horizon.

Tax exemptions for shares listed in GIFT City: The sale of foreign currency-denominated equity shares on a recognized stock exchange located in the International Financial Services Centre (IFSC) is not subject to ‘capital gains’ tax in the hands of non-resident shareholders. Hence, companies could consider listing equity shares on an IFSC stock exchange, potentially attracting non-resident investors.

Cost of acquisition of shares sold in OFS as part of IPO: In context of shares sold through an OFS, there existed an ambiguity in the tax laws concerning the determination of the Cost of Acquisition (COA) for shares acquired before February 1, 2018, and unlisted as of January 31, 2018, due to which a loophole was exploited by taxpayers to escape capital gains taxation in its entirety. The latest Budget introduces a formula indexing the purchase cost to January 31, 2018, for determining COA and the consequent tax liability on shares sold during IPOs. Notably, this amendment will be applied retrospectively, with effect from April 1, 2018, and hence promoters should assess the impact of this amendment for the concluded IPOs as well.

Cost of acquisition of shares: The cost of acquiring shares is usually the initial purchase price and in case of bonus shares it is NIL. However, subject to certain conditions for shares (including for bonus) bought before 31 January 2018, held for over 12 months, and sold post-listing, the cost can be the fair market value as of 31 January 2018, capped at the sales consideration. This 'grandfathering' provision adjusts for market value appreciation until that date, during which long-term gains were tax-exempt. This benefit applies only to shares sold on the stock exchange post-listing, not to off-market sales. Therefore, especially in a negotiated deal, it's vital for the selling shareholder to evaluate the buyer and consider if there's potential for a stock exchange sale instead of an off-market one.

Deductions from capital gains: Generally, the cost of acquisition and any transfer-related expenses, such as demat charges, broker fees, legal costs, and stamp duty are deductible whereas Securities Transaction Tax (STT) is not tax-deductible.

Valuation considerations: Indian tax laws provide valuation rules for sellers (resident as well non-resident) when selling unlisted shares and for buyers (resident as well non-resident) when acquiring listed or unlisted shares of an Indian entity. As per these rules, any transaction of shares at a price below the tax-determined fair value is considered taxable for both the seller (of unlisted shares) and buyer (of listed as well unlisted shares).

Withholding tax obligations: In an IPO, buyers must assess their withholding tax obligations, especially when dealing with non-resident sellers, as failure to comply can lead to tax recovery risks. Non-resident sellers may trigger buyer liability as a representative assessee, making indemnity or insurance crucial to mitigate risks.

Conclusion

The IPO framework in India is dynamic, appealing, providing good valuations, promoting transparency and offering benefits for both companies and investors. As India's IPO market grows, it's essential for stakeholders to stay updated on developments, anticipate tax and commercial considerations, and plan accordingly. Promoters should assess holding structures, succession planning needs, and formulate suitable strategies for a seamless IPO execution. Institutional investors should analyse their rights under existing shareholder agreements and evaluate the best means to protect them while supporting the company in the IPO process. Investors participating in the IPO should read the offer documents, understand the regulatory framework and make an informed investment decision. It is the preparedness and synergy of all stakeholders in the IPO process that will drive the IPO to be an efficient and successful one.

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