Columbia Center on Sustainable Investment
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Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues
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No. 409 May 12, 2025

Flipping and reverse flipping transactions: a concern for host economies

by

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Flipping is a corporate externalization strategy whereby a domestic startup company creates a new holding company abroad and merges its domestic company with the newly formed foreign parent company, itself becoming a wholly owned subsidiary of that foreign parent company. The domestic company transfers its entire ownership (shares and intellectual property) to the foreign entity through the exchange of domestic stock with foreign stock.

Startups from such markets as Australia, Canada, Europe, United Kingdom, Brazil, and India have adopted flipping as their offshore business strategy. The US is a popular flipping destination because of the perception of relatively easy access to capital markets, its deep, liquid and deft venture network, the scope of access to market partners, and strategic support provided by US venture capital companies, among other things. The US state of Delaware has become a hub for flip transactions, so much so that the term "Delaware Flip" has been coined.

Many Indian financial and tech startups have, since around 2010, strategically established holding companies in host countries such as the US, Singapore and The Netherlands. At the time these startups were set up in India, rapid access to the needed funding was a challenge in the country. Thus, access to finance was a dominant reason for Indian startups to venture abroad. But growth-enhancing factors such as corporate tax concessions in host economies, a favorable legal infrastructure, protection of intellectual property, and access to international markets also trigger flipping activities. Flipping transactions of Indian startups have been facilitated by the liberalization of the country's outward investment regime in 2022.

Although startups in a number of countries have adopted the flipping strategy, Indian startups that had once flipped abroad, are now "reverse flipping." Recognizing the immense potential of India—its huge market, the availability of financial and human resources, supporting economic and legislative policies—these startups are shifting their domicile back to their original home country,

India. Indian startups engaged in reverse flipping are spread across such different industries as software as a service, e-commerce and financial technology companies. Startups like Pine Labs, Groww and PhonePe, having raised venture capital abroad, have already returned to India and listed in Indian stock exchanges. Other startups, such as Razorpay, Meesho, Udaan, and Zepto, are working out their path of return.

The size of the overseas outfits of the flipped Indian startups, in terms of employment, is still relatively small. However, as flipping activities become more frequent across the world, the eventual possibility of reverse flipping by the startups, sooner or later, cannot be ignored and should be taken seriously. Thus, it becomes important to start a narrative about the possible effects of such reverse movements of capital from host economies: if the trend of reverse flipping goes global over time, the cumulative impact may be unfavorable for the foreign jurisdictions involved, both in the short and long term. Some of the detrimental effects could be:

- With reverse flipping, the original flipped investments become only a source of short-term capital flows to the host countries involved, which makes it potentially highly volatile, just as in the case of short-term foreign portfolio investment. This is disconcerting because, just like foreign portfolio investment, reverse flipping also has the risk of sudden and unexpected capital outflows that may lead to capital instability and the possibility of future macroeconomic challenges for the host economies involved, just like disruptions of trade dynamics in the event of sharp depreciations of local currencies' exchange rates, and volatility in the face of economic crises.

- When startups reverse flip, value creation (innovative ideas, disruptive technologies, economic growth) that would have occurred in foreign jurisdictions, now shifts to the original home countries.

- As startups move their operations and value-added back home, foreign countries lose the tax revenue and employment that would have been generated in these overseas jurisdictions.

To discourage reverse flipping and encourage investment retention, foreign economies could:

- Establish mechanisms for screening capital inflows, to assess their quality and stability.

- Design specific regulations for startup investment inflows that include a mandatory lock-in period for repatriation of capital back to their original home countries, to restrict unexpected capital outflows and the resulting instability overseas.

- Impose higher taxes on repatriated funds to discourage reverse flipping and/or to incentivize the investing firms to retain their funds in host countries.

- Provide tax breaks, grants or subsidies, to incentivize investing firms to retain their funds in host countries and contribute to the creation of employment, building infrastructure or conducting research.

One set of public policies may surely not fit in all flipping situations and hence would need to be tailored to specific circumstances. Nonetheless, the implementation of a combination of well-balanced measures could help host countries efficiently manage the reverse flipping of capital from themselves back to the original home countries of startup investors, like those from India.

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The author wishes to thank Sjoerd Beugelsdijk, Thomas Jost and Mira Wilkins for their helpful peer reviews.

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