Tax Issues relating to Startups

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Direct Tax Refresher Course
Pune Branch of WIRC
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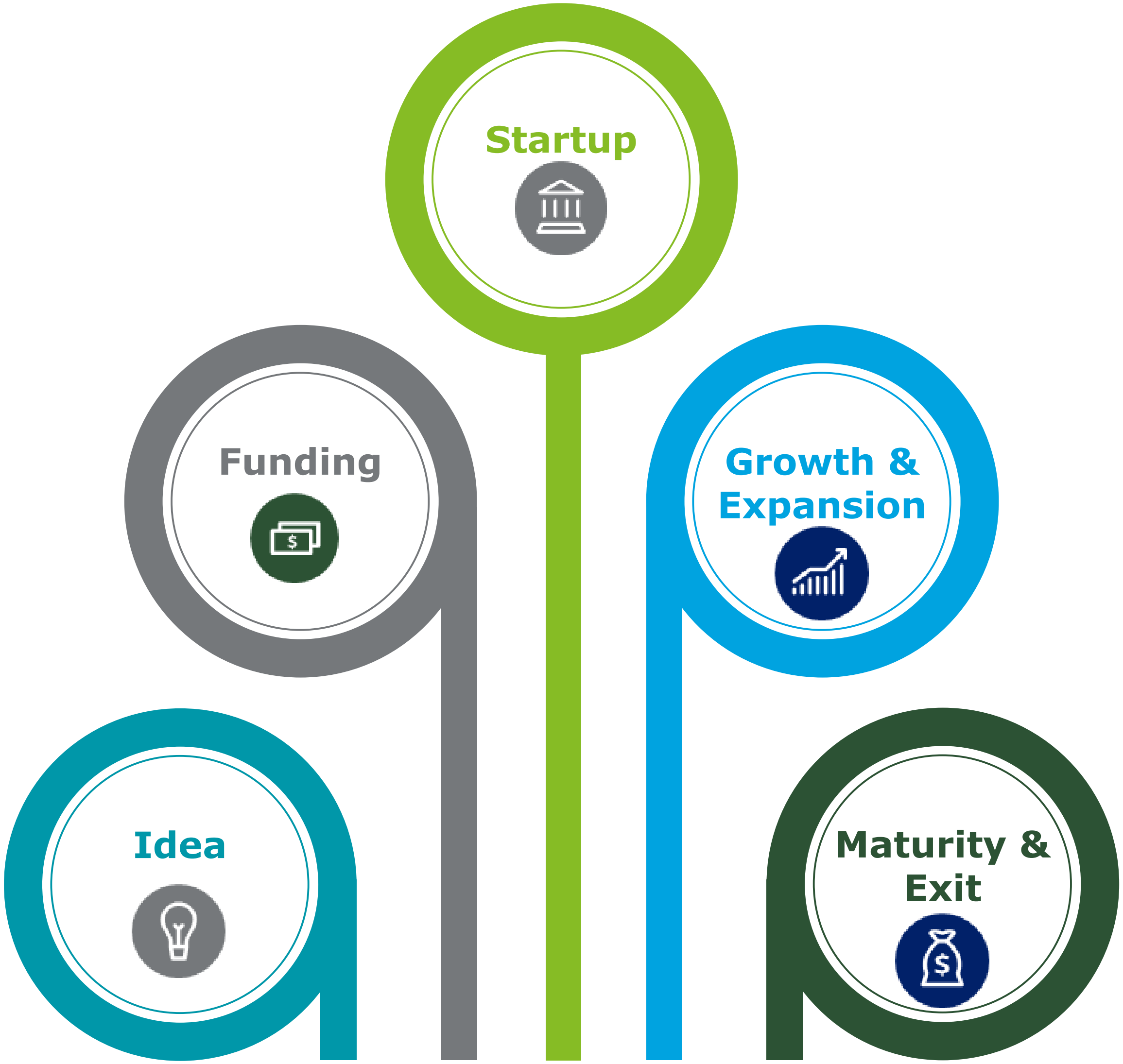
Content..

The Startup Lifecycle

The Startup Lifecycle – Stages:



Evolution of the Indian startup ecosystem

Key Events - The transition from an exotic land of spices to an exciting startup destination:

- 1984 - The liberalization of the computer industry resulted in easing of law
- 1988 - NASSCOM started with 38 members
- 1989 - Canbank VCF was the first Public Sector Bank to setup a VCF
- 1995 - The dotcom era began when VSNL launched the first commercial Internet service exposing Indians to the World Wide Web. Info Edge and Rediff.com were launched
- 1997 - ICICI Bank became the first Indian bank to offer Internet banking
- 1999 - The Indus Entrepreneurs (TiE), the world's largest network of entrepreneurs and a non-profit global community, started in Bangalore to promote entrepreneurship
- 2000 - Information Technology Act, 2000 was passed. MakeMyTrip Limited was founded and Rediff.com became India's first dotcom company to be listed on Nasdaq
- 2006 - Info Edge went public, which by then had several lucrative ventures such as naukri.com and 99acres.com. This led to the emergence of second generation Internet companies like redBus, Infibeam and bookmyshow.com. Also, the first cross-border VC from India – Nexus Ventures was founded
- 2007 - Flipkart was founded
- 2010 - MakeMyTrip went public on NASDAQ. Also, Ola, Snapdeal and Paytm were founded
- 2012 IndiaMART became the world's second-largest B2B marketplace. Also, Flipkart became the first Indian Unicorn
- 2013 - NASSCOM initiated its flagship programme, NASSCOM 10,000 startups. Thinktank iSPIRT was also founded the same year
- 2015 - Infibeam went public & became the first ecommerce company to get listed in India
- 2016 – The "Start-up India, Stand-up India" initiative was launched

Some Indian success stories

Industry: Search

Industry: Ecommerce

Industry: Fintech

Industry: Online payments

Industry: Classifieds

Industry: Travel

Industry: Ecommerce

Industry: Groceries

Industry: Social Networking

Industry: Transportation

Industry: Healthcare

Industry: Travel

The Startup India initiative

#startupindia

“I see startups, technology and innovation as exciting and effective instruments for India’s transformation.”

Shri Narendra Modi
Prime Minister of India

Startup India is a flagship initiative of the Government of India, intended to build a strong eco-system for nurturing innovation and Startups in the country that will drive sustainable economic growth and generate large scale employment opportunities. The Government through this initiative aims to empower Startups to grow through innovation and design

In order to meet the objectives of the initiative, the Hon’ble Prime Minister launched the Startup India Action Plan on 16 January 2016. The Action Plan addresses all aspects of the Startup ecosystem and hopes to accelerate spreading of the Startup movement:-

- ✓ From digital/ technology sector to a wide array of sectors including agriculture, manufacturing, social sector, healthcare, education, etc.; and
- ✓ From existing tier 1 cities to tier 2 and tier 3 cities including semi-urban and rural areas

Startup India Action Plan – Areas covered:

Simplification & Handholding

1. Compliance Regime based on Self- Certification
2. Startup India Hub
3. Rolling-out of Mobile App & Portal
4. Legal Support & Fast-tracking Patent Examination at Lower Costs
5. Relaxed Norms of Public Procurement for Startups
6. Faster Exit for Startups

Funding Support & Incentives

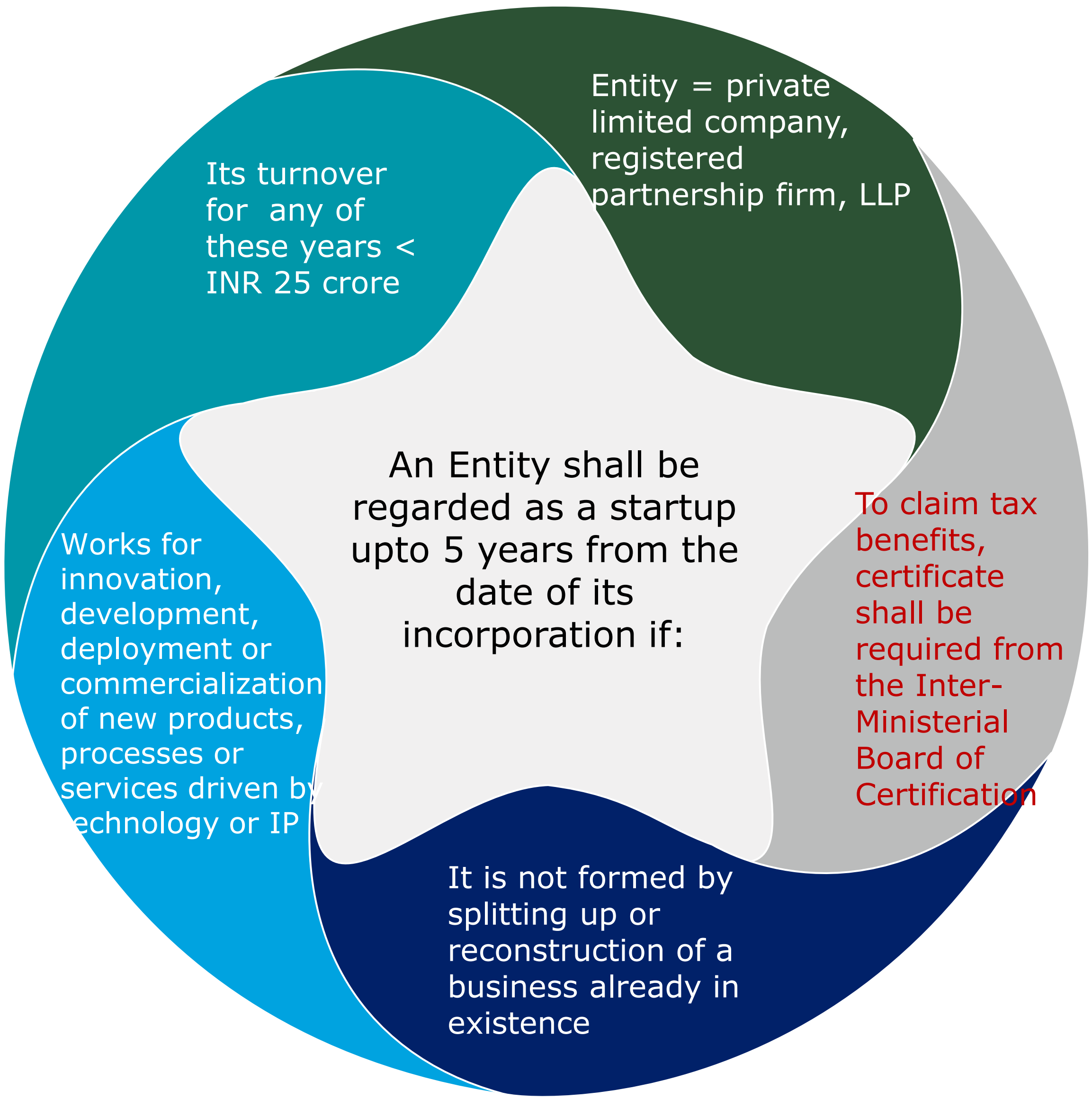
7. Providing Funding Support through a Fund of Funds with a Corpus of INR 10,000 crore
8. Credit Guarantee Fund for Startups
9. Tax Exemption on Capital Gains
10. Tax Exemption to Startups for 3 years
11. Tax Exemption on Investments above FMV

Industry-Academia Partnership & Incubation

12. Organizing Startup Fests for Showcasing Innovation & Providing a Collaboration Platform
13. Launch of Atal Innovation Mission (AIM) with Self-Employment & Talent Utilization (SETU) Program
14. Harnessing Private Sector Expertise for Incubator Setup
15. Building Innovation Centres at National Institutes
16. Setting up of 7 New Research Parks Modeled on the Research Park Setup at IIT Madras
17. Promoting Startups in the Biotechnology Sector
18. Launching of Innovation Focused Programs for Students
19. Annual Incubator Grand Challenge

Earlier provisions (DIPP’s Notification dt. 17 February 2016):
Startup – Definition
Startup - Process of Recognition

Definition – DIPP's Notification dated 17 February 2016:



An entity is considered to be working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or IP if it aims to develop & commercialize:

a. A new product, service or process, or
b. A significantly improved existing product, service or process, that will create or add value for customers or workflow

Provided that the mere act of developing:

a. Products, services or processes which do not have potential for commercialization, or
b. Undifferentiated products, services or processes, or
c. Products, services or processes with no or limited incremental value for customers or workflow

would not be covered

Process of Recognition – DIPP's Notification dated 17 February 2016:

An online application for registration as a startup shall be e-filed through the portal (startupindia.gov.in) or mobile app, along with ANY ONE of the following documents:

- A recommendation (with regard to innovative nature of business), in a format specified by DIPP, from any Incubator established in a postgraduate college in India; or
- A letter of support by any Incubator which is funded (in relation to the project) from Government of India or any State Government as part of any specified scheme to promote innovation; or
- A recommendation (with regard to innovative nature of business), in a format specified by DIPP, from any Incubator recognized by Government of India; or
- A letter of funding of not less than 20% in equity by any Incubation Fund/Angel Fund/Private Equity Fund/Accelerator/Angel Network duly registered with SEBI that endorses innovative nature of the business. DIPP may include any such fund in a negative list for such reasons as it may deem fit; or
- A letter of funding by Government of India or any State Government as part of any specified scheme to promote innovation; or
- A patent filed and published in the Journal by the Indian Patent Office in areas affiliated with the nature of business being promoted

A recommendation or letter of support or funding, was mandatory for recognition

Incubator - Meaning & Process of Recognition

Incubator - General Meaning:

An entity engaged in fostering an incubatee (interalia a startup) through the developmental phases until such time as the incubatee has sufficient financial, human and physical resources to function on its own

Assistance may be provided via any or all of the following methods, usually in exchange for equity stakes in the incubatee:-

1. Access to financial capital through relationships with financial partners;
2. Access to experienced business consultants and management-level executives;
3. Access to physical location space and business hardware or software;
4. Access to informational and research resources via relationships with local universities and government entities

Incubator - Need for Recognition:

Under the earlier provisions, startups seeking registration had to submit a recommendation letter from any incubator recognized by the Government of India

Recognition of incubators is with a view to provide startups access to a wider base of incubators that are eligible to provide the said recommendation letter

A recognized incubator can also endorse an idea/ startup not incubated in such incubator. The objective of the recommendation is to validate that a startup is involved in an eligible business

Process & Parameters for Recognition – Guidelines on startupindia.gov.in:

- An online application for registration as an incubator shall be e-filed through the portal (startupindia.gov.in) or mobile app
- The incubator shall authorize a person to provide the required information on its behalf
- The application shall be scrutinized and evaluated against the parameters below

<table>
<tr><td>Eligibility</td><td>Must be a registered entity falling under one of the following categories:
• Society (under The Societies Registration Act, 1860)
• Section 8 Company (under The Companies Act, 2013)
• Private Limited Company (under The Companies Act, 2013)
• Public Company (under The Companies Act, 2013)
• LLP (under The Limited Liability Partnership Act, 2008)</td></tr>
<tr><td>Number of years of establishment</td><td>Should be in existence for at least the last 2 years. This benchmark of existence for at least 2 years shall not be applicable for incubators which have received a sanction letter by the Central/ State Government</td></tr>
<tr><td>Number of incubatees currently enrolled</td><td rowspan="2">The incubator should have a minimum of 20 incubatees graduated or on rolls at present i.e. at the time of filling of application. For incubators which have received a sanction letter by the Central/State Government, a minimum of 5 incubatees should have graduated or on rolls at present i.e. at the time of filling of application</td></tr>
<tr><td>Number of incubatees graduated</td></tr>
<tr><td>Availability of Infrastructure</td><td>The incubator should have a minimum of 5000 sq. feet of carpet area dedicated to the incubatees</td></tr>
<tr><td>Contact period of engagement</td><td>The incubator should facilitate at least 3 months of in person or virtual interactions between its incubatees and mentors</td></tr>
</table>

Process & Parameters for Recognition – Guidelines on startupindia.gov.in:

- After receiving the required information, the application shall be forwarded for approval of the Inter-Ministerial Board, post which a certificate of recognition shall be issued to the incubator. The certificate shall be system generated, online and downloadable
- Recognition shall be valid for 2 years from the date of grant of recognition
- It may be revoked if the incubator misrepresents information or does not justify its role
- A recognized incubator shall be evaluated against the following parameters after 6 months of obtaining recognition

Engagement with VCF/ AIF	The number of tie-ups between the Incubator and VCF, AIF shall be considered
Engagement with Corporates	The number of tie-ups between the Incubator and Corporate Organizations to provide industry exposure to the Incubatees shall be considered
Number of mentors	The number of mentors providing in person or virtual mentorship to the Incubatees shall be considered
Number of outreach programmes conducted	The number of outreach programmes conducted in the previous one year shall be considered

- For extension of recognition post expiry of the period of recognition, a fresh application shall be submitted at least 3 months prior to such expiry
- A recommendation issued without verification may lead to blacklisting of the issuing incubator

#startupindia - Status Report dated 15 May 2017

#startupindia - Status Report dated 15 May 2017:

DIPP has recognized 932 startups

23 startups have been approved for availing tax benefits by the Inter-Ministerial Board

Startup India hub handled more than 48,000 queries and facilitated more than 380 Startups by providing advisory on business plans, pitching support, etc

A 'fund of funds' of INR 10,000 crores is being managed by SIDBI. INR 623.5 Cr have been committed to 17 AIFs.
62 Startups funded

New Incubators are being set up & a scale-up grant of INR 10 crore has been approved for established incubators

A 4 week free Learning & Development programme covering 6 modules has been launched. More than 1,29,000 applicants signed up for the course and 4,300 applicants completed the course successfully

DIPP has written to MCA to notify Startups as Fast Track firms. Once notified, Startups shall be able to wind up their business within a period of 90 days

15 States have formulated Startup Policies

Startup India - Discussion:

The Startup India initiative did not take off as envisaged with only 23 startups succeeding in qualifying for tax benefits after going through the process

The main reason being the subjective nature of some of the qualification parameters, eg: eligible business means an innovative business driven by technology or IP. Hence will a business which does not rely heavily on technology or IP, but nonetheless offers a solution to some fundamental problem, meet the requirement?

Another reason for the poor response was that 5 years is perceived as too short a period for startups to turn profitable

The Government had received representations from the industry seeking changes to the definition of startup and easier norms to make the process simpler

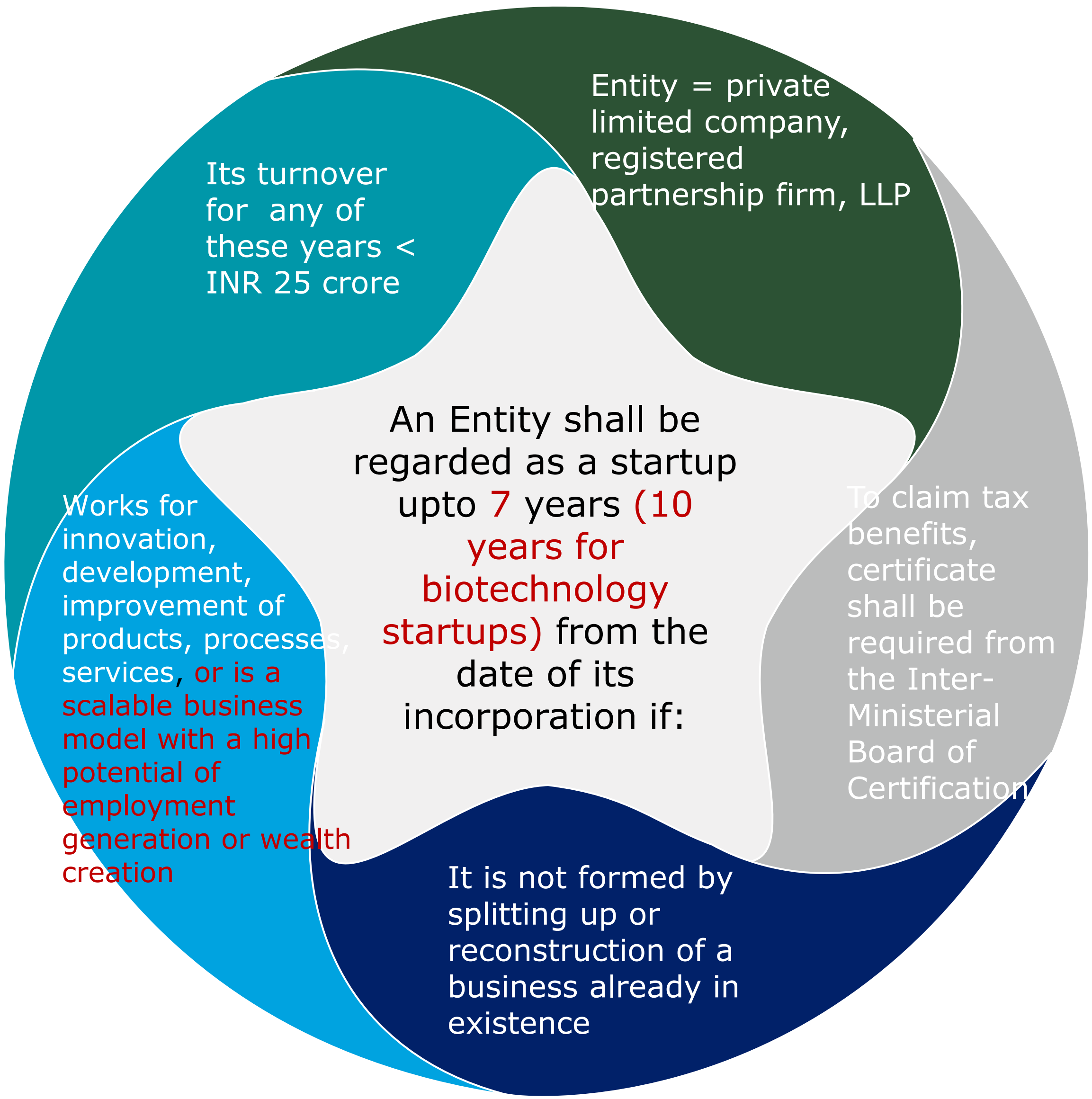
Based on a detailed review and also to align with the amended income-tax holiday provisions, DIPP announced a revised definition of the term ‘startup’ and an entrepreneur-friendly recognition process on 25 May 2017

Revised provisions (DIPP’s Press release dt. 25 May 2017):

Startup – Definition

Startup - Process of Recognition

Revised Definition – DIPP's Press release dated 25 May 2017:



The Press release states that:

"As a constant endeavour to facilitate the startup ecosystem, the DIPP has been holding extensive consultations with stakeholders. The above changes are an effort to ensure ease of starting new businesses to promote the startup ecosystem and build a nation of job creators, instead of job seekers,"

Revised Process of Recognition – DIPP's Press release dated 25 May 2017:

An online application for registration as a startup shall be e-filed through the portal (startupindia.gov.in) or mobile app, along with :

- Certificate of Incorporation or Registration
- A brief note on innovativeness/scalability of business model/ potential of employment generation/ wealth creation

A recommendation or letter of support or funding, is no longer required

A Comparison:

	Earlier Provisions	Revised Provisions
Period of recognition from the incorporation	5 years	10 years for biotechnology startups; 7 years for other startups
Eligible business	Innovation, development, etc. of a new product, process or service or of a significantly improved product, process or service	The existing scope has been broadened to also include a scalable business model with a high potential of employment generation or wealth creation
Process of recognition	Recommendation or a letter of support from an Incubator or a letter of funding, was mandatory	Only the incorporation certificate and a note on innovativeness, potential of employment generation or wealth creation has to be furnished
Approval of the Inter-Ministerial Board for claiming tax benefit	Required	Required

Tax holiday – section 80-IAC

Tax holiday – Provisions:

Eligible start-up:

Means a company or LLP:

- Incorporated after 1 April 2016 but before 1 April 2019;
- Having total business turnover not exceeding INR 25 crore during the FY from 2016-17 to 2020-21; and
- Holding a certificate of eligible business from the Inter-Ministerial Board of Certification

Deduction of 100% of the profits derived by an eligible start-up from an eligible business (inserted by the Finance Act, 2016 w.e.f. 1 April 2017)

Eligible business:

A business involving innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property

Tax holiday period:

3 consecutive years out of 5* years beginning from the year of incorporation

* extended to 7 years by the Finance Act, 2017 w.e.f 1 April 2018

Applicable condition:

Is not formed by splitting up or reconstruction of an existing business or by transfer of previously used machinery

Tax holiday – Discussion:

Since the launch of the Startup India programme, only 23 startups have been approved for availing tax benefits by the Inter-Ministerial Board as of the 1st week of May 2017*. The approval process needed simplification, scaling up & substantial acceleration – Norms have been eased out vide the DIPP's Press Release dated 25 May 2017

Source: #startupindia – Status Report dated 15 May 2017

As the definitions of 'eligible startup' and 'eligible business' u/s 80-IAC are not linked to the announcements made by DIPP, the expanded definition may not achieve its intended objectives until a corresponding amendment is made to the ITA

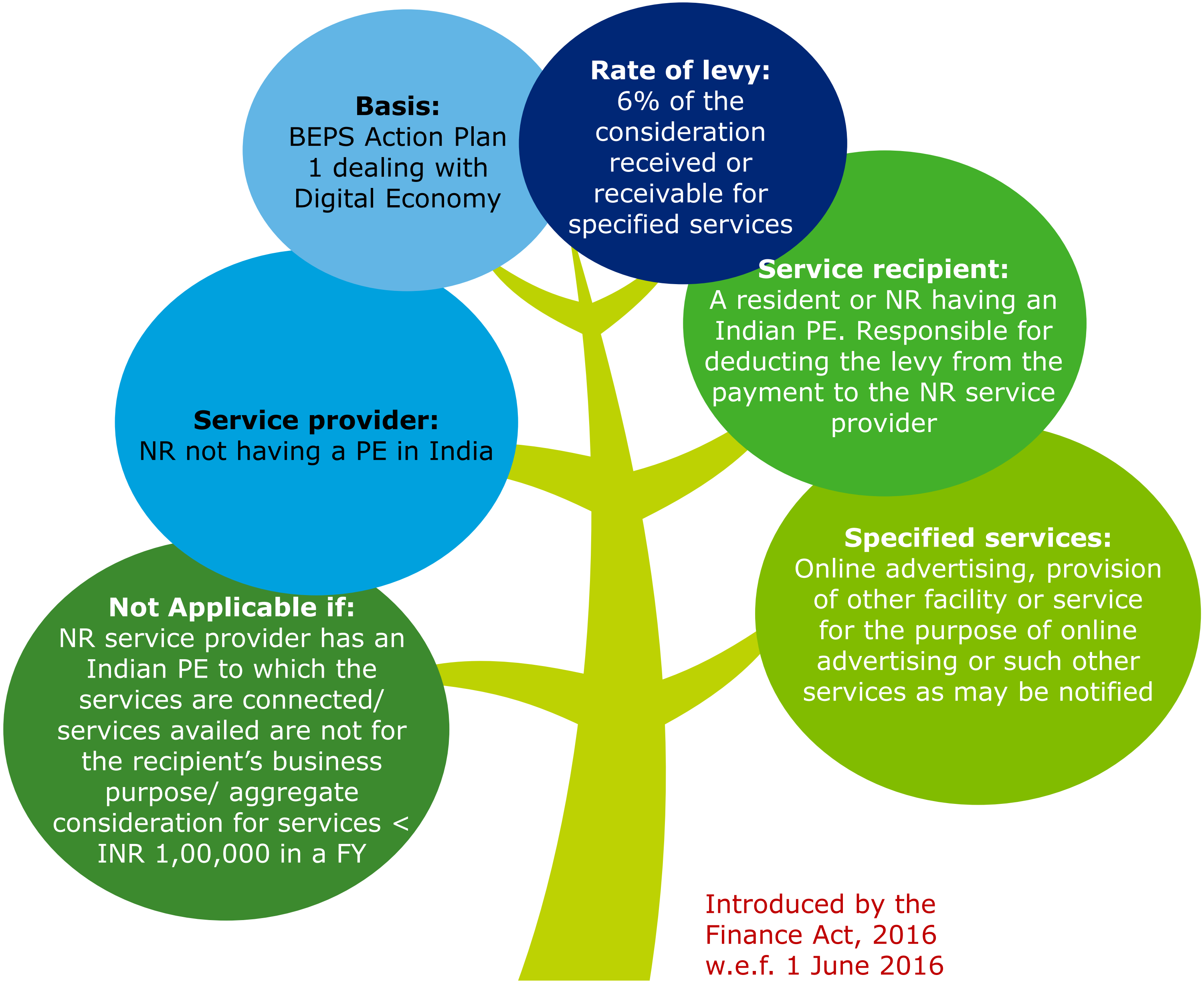
Clarity is required on what constitutes a 'scalable business model' and what level of employment generation or wealth creation is 'high' enough to be regarded as an eligible start-up

A survey conducted by Moneycontrol.com during January 2017 reveals that a five-year tax holiday tops the list of startup-friendly rules that Indian entrepreneurs seek from the government

Under the amended provisions, a start-up incorporated in March 2019 would be eligible to claim the deduction for 3 consecutive years out of 7 years until March 2026. However, the turnover threshold of INR 25 crores is applicable till March 2021. Clarification is required on the turnover threshold for deduction to be claimed after March 2021

Equalisation levy – Chapter VIII of the Finance Act, 2016

Equalisation levy – Provisions:



Equalisation levy - Discussion:

Comparatively lower cost and wide customer reach makes the online media a big favourite; startups spend almost 40% of their budget on online ads

As the levy does not qualify as income tax or service tax, tax credits are not available either under DTAA or under domestic service tax laws. There is hence a high probability that the NR service provider may seek net of tax payments. Limited bargaining power may result in higher advertising costs for startups

If passed on to startups, the applicable tax presently works out to roughly 22% including service tax. This may further increase substantially under the GST regime

Expansion of the notified services liable for the levy, could lead to further costs

Despite representations, these issues remained unaddressed in the Budget 2017

Thin capitalization – section 94B

Thin capitalization – Provisions enacted by the Finance Act, 2017:

- W.e.f. 1 April 2018, deduction of interest or 'similar consideration' paid or payable by an entity to its NR AE shall be restricted to 30% of its EBITDA
- Applies to an Indian company, or an Indian PE of a foreign company, being the borrower, who pays interest or similar consideration in respect of any debt issued by an NR AE (including provision of an implicit or explicit guarantee or deposit of matching funds by an AE with a non-AE lender)
- Applies where interest or similar consideration payable to the NR AE exceeds INR 1 crore
- Disallowed interest expense shall be carried forward upto 8 subsequent AYs: Deduction of such disallowed interest in subsequent AY, shall also be subject to the restrictions of section 94B
- 'Debt' means any loan, financial instrument, finance lease, financial derivative, or any arrangement that gives rise to interest, discounts or other finance charges that are deductible in computing business income

Thin capitalization - Discussion:

Many Indian startups have foreign venture capital funding. Further, most startups require time to turn profitable and have very low EBITDA in the initial years. The provision hence adds pressure on such loss-making startups. Even the permitted carry forward of the disallowed interest may not help in these cases as the deduction in the subsequent year is again subject to the restriction u/s 94B

News reports* stated that startups had demanded an exemption from the thin capitalization restrictions when the Finance Bill, 2017 was under debate in the Lok Sabha

** Business Standard dated 21 March 2017*

Carry forward & Set off of business loss – section 79

Carry forward & Set off of business loss – Provisions:

Earlier provisions

In the case of a closely held company, business loss incurred in a prior year shall not be carried forward and set off unless shares of the company carrying not less than 51% of the voting power on the last day of such subsequent year, were beneficially held by persons holding these shares on the last day of the year in which the loss was incurred

section 79

Amended provisions

While the earlier provisions continue to apply in the case of other closely held companies, the Finance Act, 2017 has provided the following relaxation to eligible startups w.e.f. 1 April 2018:

- Eligible startups referred to in section 80-IAC can carry forward and set off business loss against the income of a subsequent year, irrespective of a change in shareholding but subject to the condition that all the shareholders holding shares carrying voting power on the last day of the year in which the loss was incurred, continue to hold those shares on the last day of the year in which such loss is to be set-off
- Change in shareholding due to death of shareholder, gift to a relative or merger, demerger of foreign parent, is permitted
- The loss should be incurred during the period of seven years beginning from the year in which such company is incorporated

Carry forward & Set off of business loss - Discussion:

As stated earlier, a mere handful of startups have been notified for tax benefit by the Inter-Ministerial Board till May 2017. Hence until acceleration of the approval process, the relaxation may be of little help given that it only applies to eligible startups referred to in section 80-IAC of the Act – Approval norms have been eased out vide the DIPP’s Press Release dated 25 May 2017

The relaxation would also not apply if an otherwise eligible startup ceases to be eligible, say due to its business turnover of any year exceeding the threshold of INR 25 crore as prescribed in section 80-IAC

The condition that all the shareholders during the year of loss should continue holding shares during the year in which the set off is sought to be made, may be practically difficult to achieve as private equity investors generally look at a time frame of 3 to 5 years for exit at a higher price. However, in terms of the amended provisions, even a single such exit could lead to denial of loss set off

MAT

MAT - Discussion:

MAT provisions apply to startups; even to those enjoying tax holiday u/s 80-IAC. The MAT liability adds to their already stressed cash flows. Hence exemption from MAT has been a repeated demand on most of the startup Budget wish lists

In his Budget 2017 speech, the Finance Minister while acknowledging the strong demand for abolition of MAT, stated that the same was not practical at present due to the phasing out of various exemptions from 1 April 2017. W.e.f. 1 April 2018, the Finance Act, 2017 has however extended the period of carry forward of MAT credit to 15 years from the extant 10 years

Capital Gains taxation for investors

Exempt LTCG u/s 10(38) - Provisions:

Earlier provisions

LTCG arising on transfer of listed equity shares is exempt where:-

- Transfer of shares is on or after 1 October 2004; and
- The transaction is subject to STT

Anti-abusive measure - Finance Act, 2017

Exemption would not be available:-

- If the transaction of acquisition of equity shares is entered into on or after 1 October 2004; and
- Such acquisition is not chargeable to STT

Acquisitions as may be notified* by the Central Government, can continue to claim exemption

CBDT issued a draft notification last month proposing a negative list i.e. stating that the condition of chargeability to STT shall not apply to all acquisitions of equity shares entered into on or after 1 October 2004, other than the transactions specified in the draft notification

Exempt LTCG u/s 10(38) - Discussion:

ESOP represent a powerful wealth-creation instrument that cash-strapped startups use to motivate employees

One of the specified transaction as per the draft notification includes a case where a transaction for purchase of listed equity share in a company is not entered through a recognised stock exchange i.e. the condition of chargeability to STT would apply to such acquisitions. There is apprehension that the tax authorities may argue that this would cover ESOP. Hence an express clarification is desirable on whether exemption would be available if listed equity shares acquired by an employee through ESOP are transferred

In the case of Uday Punj [2012](348 ITR 98)(Del HC), the assessee was a promoter/director of a company whose shares were not listed initially. The company subsequently came out with an IPO, which permitted the existing shareholders to offer their shares for sale to the general public. The assessee offered some shares for sale and received a consideration. The listing approval by the Stock Exchanges took place subsequently and STT was not paid on the sale. The Delhi HC held that as the transfer was completed prior to the listing, the shares were not 'listed securities' at the time of sale. Hence the transaction would not be eligible for payment of capital gains tax at the lower rate of 10% in terms of section 112

Taxability of earn-out payments - Discussion:

Earn-out payments are typically calculated on the profits of the target company, and are made to the seller in years subsequent to the transfer. In case of exit by promoters & investors, very often the consideration receivable is composed of two components – (1) a fixed amount and (2) a performance based or formula based contingent amount that is not ascertainable in the year of transfer

The taxability of such deferred consideration in the year of transfer has been a debated issue - In Anurag Jain [2009](277 ITR 1)(AAR), it was ruled that as the Share Purchase Agreement was linked to the Associate Employment Agreement entered between the Applicant and the Company whose shares were being transferred, contingent consideration for transfer of shares was in substance a payment to ensure employment performance that was hence taxable as salary. The Writ Petition filed against the AAR ruling was dismissed by the Madras HC [2009](308 ITR 302) by stating that its jurisdiction in a Writ was restricted to testing the legality of the procedure followed and not the validity of the AAR's order. Further, in Ajay Guliya [2012](209 Taxman 295)(Del HC), it was held that in terms of section 45(1), the entire consideration is taxable in the year of transfer even if a part thereof is a deferred payment based on future contingencies. The Madras HC had earlier held in T.V. Sundaram Iyengar & Sons Ltd. [1959](37 ITR 26)(Mad HC) that if the entire consideration is not received in subsequent years, such non-payment may be considered as a capital loss in the year when such consideration becomes irrecoverable

Last year, the Bombay HC however held in Hemal Raju Shete [2016](ITA No. 2348 of 2013)(Bom HC) that when deferred consideration for transfer of a capital asset is contingent upon one or more uncertain events, such deferred payment is not taxable in the year of transfer if it has not accrued to or been received by the transferor in that year. The HC observed that the amount cannot be said to have accrued until such contingent event is realized. The above cited Delhi HC ruling was however not referred

FMV based taxation on transfer of unquoted shares:

- New section 50CA inserted by the Finance Act, 2017 provides that if sale price of unquoted shares < FMV, FMV shall be deemed as full value of consideration

- CBDT has issued a draft notification prescribing manner of FMV determination

- The draft notification provides that FMV of unquoted equity shares is the aggregate of:

  (i). Book value of all assets (other than jewellery, artistic works, shares, securities and immovable property) of the company;

  (ii). Market price of jewellery or artistic works;

  (iii). Fair value of shares or securities (i.e. lowest traded price on any recognized stock exchange for a quoted security and for unquoted shares as per the prescribed method);

  (iv). Stamp duty value in respect of immovable property;

  And as reduced by the Book value of Liabilities appearing on the valuation date

The above manner of FMV determination may pose difficulties in the case of multiple holdings, cross holdings, assets held for business purpose by real estate or investment startups, preference shares, etc.

Some Miscellaneous Provisions:

Holding period
section 2(42A)

Listed shares: 12 months
Unlisted shares: 24 months

Tax rate
section 112

LTCG on transfer of unlisted shares:
NR transferor - @ 10% (without giving effect to the first & second proviso to section 48)

Resident transferor - @ 20%

Exempt LTCG
section 54GB

Exempts LTCG arising on transfer of original units of a notified fund, if invested in units of fund notified by the Central Government

section 54EE

Exempts LTCG arising on transfer of a residential property, if utilized for subscribing to the shares of an eligible start-up u/s 80-IAC

Some Miscellaneous Provisions - Discussion:

As angel investors take a much higher risk when investing in startups as compared to publicly listed companies and further to eliminate the discrimination between resident and NR investors, there has been repeated lobbying that the taxation of sale of unlisted shares be brought at par with taxation of listed shares/ NR investors in terms of the holding period, tax rate

The exemption u/s 54GB applies only to LTCG (on sale of residential property) invested in shares of an 'eligible startup referred to in section 80-IAC'. The exemption would not be available for investment in other startups

The industry demand is for exemption of gains from sale of equity of a startup if the proceeds are reinvested in securities of new startups

Angel tax – section 56(2)(viib)
Unexplained cash credit - section 68

Angel tax – Provisions:

Anti-abusive provision introduced by the Finance Act, 2012

Applies to closely held companies issuing shares to a resident

Consideration received for issue of shares (-) FMV of such shares is taxable as Income from Other Sources

Does not apply to consideration for issue of shares received by:

(i) a venture capital undertaking from a venture capital company or a VCF; or

(ii) a company from a class or classes of persons as may be notified* by the Central Government in this behalf

Section 56(2)(viib)

* Notification No. 45/2016 dated 14 June 2016 provides that the 'classes of persons' would include 'person' defined u/s 2(31) of the Act, being a resident, who makes any consideration exceeding the face value for issue of shares of a 'startup' company.

For the purpose of the notification, 'startup' means a closely held company which fulfils the conditions specified in DIPP's notification dated 17 February 2016

Angel tax – Provisions (Contd..):

For the purpose of section 56(2)(viib), FMV shall be the higher of:

- The value determined on applying Rules* 11U and 11UA of the ITR; or

- The value as may be substantiated to the AO's satisfaction, based on the value, on the date of issue of shares, of the company's assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature

*Rule 11UA read with Rule 11U provides the assessee an option to determine FMV:-
  - Either based on the Net Book Value of Assets & Liabilities;
  - Or as determined by a SEBI registered Category I merchant banker or an accountant as per the Discounted Free Cash Flow method

Unexplained cash credit – Provisions:

Section 68:
Any sum credited in the books of a closely held company on account of share application, share capital, share premium or any such amount shall be taxed as unexplained cash credit if the source of the investment is not satisfactorily explained by such company as well as by the resident investor (other than a VCF or a venture capital company) in whose name such credit is recorded

Angel tax & unexplained cash credit - Discussion:

Startup ventures, at the stage where angels invest, mostly have no revenues or profits and the valuation is based on the potential & promise of the idea, the background & competence of the founding team and is usually a matter of negotiation between the founders and the angel investors. Practically there is hence no concept of FMV for such companies and the decision to invest is largely a judgment call

The relief granted vide Notification dated 14 June 2016 applies only to eligible startups fulfilling DIPP’s requirement. Angel tax applies to the balance majority startups

News reports* state that tax notices u/s 56(2)(viib) have been issued to about 100 startups (incorporated before February 2016) with marked down valuations, requiring payment of angel tax. Tax officers have challenged duly certified valuation methodology, assumptions and projections. Eg: Based on a certain valuation, a startup issued shares at Rs 100 per share in its first round and at Rs 80 per share in the next round due to a downward revision in its valuation. As per the tax department, the difference of Rs 20 between the second and the first rounds, is an excess consideration taxable u/s 56(2)(viib)

Tax notices u/s 68 have also been issued to resident investors of these startups, requiring explanation of the source of their investments

** The Economic Times dated 4 January 2017, Bloomberg Quint dated 16 January 2017*

Despite representations, these issues remained unaddressed in the Budget 2017

Other direct tax incentives

Other direct tax incentives:

Finance Act, 2017

- **Reduced corporate tax rate:** A tax rate of 25% (instead of 30%) would apply to a domestic company having total turnover or gross receipt not exceeding INR 50 crore during FY 2015-16

- **section 47(xb)**: Conversion of preference share of a company into equity share of that company shall not be a taxable transfer liable to capital gains tax

TDS

TDS - Discussion:

As TDS compliance adds to the administrative burden and costs, TDS default is very common among startups. Interest, penalties and fines for TDS default add to the cost

Raising of TDS thresholds and rationalization of the TDS compliance structure for startups is a long requested tax-sop

Impact of Revision to the Mauritius, Cyprus & Singapore DTAA

Impact of Revision to the Mauritius, Cyprus & Singapore DTAA - Discussion: Other Startups funded by Foreign VCs/PEs

Mauritius, Cyprus & Singapore routes into Indian start ups & businesses. Largely plugged from 1.4.2017.

Very often start ups were required the investee Indian company to set up shop in the above jurisidctions to subject its Indian business to a holding relationship with such overseas company mainly for divestment and tax reasons.

The cost of "externalising" startup businesses to these jurisidctions and related Indian laws including FEMA needed to be examined.

The onset of GAAR and the revision to India's DTAA with the tax haven, have largely closed the above 'routes'

Foreign investment rides on the back of Indian entrepreneurship, domestic investment, potential of the Indian market, and is not driven by capital gains exemption alone. There is hence reason to hope that any dip in foreign investment would be temporary

Abbreviations:

AE	Associated Enterprises
AIF	Alternative Investment Fund
AY	Assessment Year
CBDT	Central Board of Direct Taxes
DIPP	Department of Industrial Policy & Promotion
DTAA	Double Taxation Avoidance Agreement
EBITDA	Earnings before interest, taxes, depreciation & amortization
ESOP	Employee Stock Option Plan
FY	Financial Year
GAAR	General Anti-Avoidance Rule
GST	Goods and Services Tax
INR	Indian Rupees
IP	Intellectual Property
IPO	Initial Public Offering
ITA/ the Act	Income-tax Act, 1961
ITR/ the Rules	Income-tax Rules, 1962
LTCG	Long-term Capital Gains
MAT	Minimum Alternate Tax
MCA	Ministry of Corporate Affairs
NR	Non-resident
PE	Permanent Establishment
P&L	Profit & Loss Account
STT	Securities Transaction Tax
SEBI	Securities and Exchange Board of India
TDS	Tax Deducted at Source
VCF	Venture Capital Fund
r.w.s.	Read with section
u/s	Under section
w.e.f.	With effect from

Thank You