

Tax Wire



Government frees 'Startup' from 'Angel Tax'

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Background

Infusing unaccounted money into closely held companies by issuing shares at abnormal premiums was a practice that prevailed as a method to convert unaccounted money into accounted money. In order to curb such practice, the Government had introduced section 56(2)(viib) in the Income Tax Law (ITL) in 2012.

According to this, money received by the unlisted company against the issue of shares at a premium, to the extent the same is in excess of the Fair Market Value constitutes income to such company. Such extra inflow is taxable as "Income from Other Sources" under ITL. To arrive at FMV, methods were prescribed and a certificate from a Merchant Banker or a Chartered Accountant was required. Further, these provisions were not applicable for money received by a Venture Capitalist (VC) from VCC or VCF; and such class of companies that are to be notified by the tax board.

As a result of the above, companies were cautious in issuing the shares at unjustifiable premiums. There were also instances of tax authorities picking up the cases for scrutiny only on the grounds of huge share premiums appearing in the financials.

Controversies and the Dilemma

The entrepreneurial scene in India has gained a lot of momentum in the last few years. We have had a host of companies being called the 'unicorns' in the investment circles for the enormous valuations that they have achieved. This was followed by innumerable companies without any established business and value base and only based on a business plan or idea, being valued at very premiums. This had its shelf life and over the last 6 months, such valuations are

overturning. Valuation of startup has fallen sharply, recently, on worries over profitability, growth and intense competition.

Around this time, there were also news paper reports that the Income-Tax Department discussed a controversial move to impose tax on those startup under the garb of Section 56(2)(viib) on the ground that since their valuation has fallen currently, they were overvalued initially when the issue of shares happened in the previous rounds. This move is likely to upset startup who were already worried over funding issue and falling valuations.

Current Notification

The Central Board of Direct Taxes (CBDT) in mid June 2016, came out with a notification bearing no. **45/2016** notifying the class of persons to whom this notification does not apply. This notification describes that when a 'startup' receives any money from any angle investor/fund house or any person resident in India, such sum towards issue of shares need to be tested with FMV. Thereby, the issue of shares can be at any value.

It is very important to note that this relaxation is only applicable to 'startup' as defined by notification of Department of Industrial Policy and Promotion (DIPP) under the 'Startup India' scheme, which is as under:

- i. An entity which is in existence upto five years from the date of its incorporation.
- ii. Its turnover for any of the financial years has not exceeded Rupees 25 crore.
- iii. It is working towards innovation, development, deployment or commercialization of new products, processes or services

driven by technology or intellectual property.

- iv. It obtains a certificate of an eligible business from the Inter-Ministerial Board of Certification.

Conclusion

It is a good move considering that now the 'startup' will not have to worry about FMV while raising their funds. They would not have to go through the rigorous questioning and scrutiny of the tax authorities who seem to be extremely disconnected with the business realities and the new age businesses. The tax authorities only seem to be viewing everything with the prism of accounted and unaccounted money and taxation. This notification should pave way for further investment to happen in real value adding startup.

It is very important for the authorities to understand that there can be taxation only if businesses prosper and creating such environment is the responsibility of the administration.

Though this notification has exempted the 'startup' as defined above from the rigours of FMV computation, it does not exempt such entities which do not fall within the above definition. Moreover, proviso to section 56(2)(viib) gave power to CBDT to notify class of investors and not class of investees. Somehow, this notification seems to have notified the class of

investee by morphing it as though notifying the class of investors. We need to await to see if this notification gets questioned on its validity or not.

It could still be fair from the Government side to continue with this provision to keep a watch on the unaccounted money inflow into the system through this route, the controversial move that the tax department is contemplating to levy tax based on fall in valuation is highly regressive.

Valuation of an early stage entity happen based on various factors including the intrinsic worth of the idea, the size of the market that it is trying to tap, the general economic factors that influence business and also the market forces. This could change with circumstances and time, which could influence the valuation. Merely because the valuation falls at a later stage does not mean that the valuation early was incorrect. Hope right sense prevail at the tax administration.

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