Tax Wire

Tax Benefit for Start-ups – an overview

24th April, 2018

adrith
CONSULTING

adwith CONSULTING

Tax Benefit for Start-ups – an overview

Background

To keep a check on the closely held companies from bringing in undisclosed income into the company by issuing the shares at abnormal premium, section 56(2)(viib) was introduced into the Income Tax Act, 1961(the Act) by the Finance Act 2012.

According to this, whenever a closely held company issues shares to resident investors at a price that is over and above the Fair Market Value(FMV) then, the amount received in excess of the FMV will be treated and chargeable to tax as Income from Other Sources. In order to arrive at the FMV, methods were prescribed in Rule 11UA of the Income Tax Rules,1962 (the Rules) and a certificate either from a Merchant Banker or from a Chartered accountant was required in this respect. Further, it was also stated that these provisions are not applicable for the funds received by:

a) Venture Capital undertaking (VCU) from a VCC or VC Fund and
b) such classes of persons as may be notified by the Central Government.

This taxation was loosely called as '**angel tax**[1]'.

Start-up India Initiative

With the aim of fostering entrepreneurship and promoting innovation by creating an ecosystem that is conducive for growth of start-ups and to enable India to become a nation of job creator instead of a nation of job seekers, the Government of India launched the "Start-up India" initiative on 16th January,2016. In this connection, Finance Act 2016 introduced section 80-IAC into the Act to provide incentive to start-ups by way of 100% tax exemption for 3 consecutive years out of the first 5 years starting from the year in which the entity gets incorporated.

Notifications by DIPP and CBDT- Till date

First notification of DIPP

Department of Industrial Policy and Promotion (DIPP) was entrusted with the responsibility to administer the Start-up India scheme. DIPP issued notification on 17th February,2016 defining the word start-up and mentioning the procedure to obtain recognition as start-up with DIPP. As per this notification the entity i.e. a Private Limited Company or a Registered Partnership Firm or an LLP shall be considered as start-up,

- Up to 5 years from the date of its incorporation/registration.
- The turnover for any financial year does not exceed INR 25 crores and
- It is working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

Further, the notification clearly specified that any entity formed by the splitting up or reconstruction of an existing business shall not be considered as a start-up.

The notification furthermore added that the DIPP recognised start-ups to obtain a Certificate of an Eligible Business from the Inter-Ministerial Board of Certification in order to obtain tax benefits.

Notification of CBDT

Following this during the year 2016, The Central Board of Direct Taxes(CBDT) issued a notification *exempting the 'start-ups' from angel tax*, that receive funding

[1] There is no such term defined under any legislation. For ease of understanding, we have continued to use this term in the entire document

from angel investors/fund house or any person resident in India[2].

It is pertinent to note that only 'start-up' satisfying the definition, obtain the recognition from DIPP and which has received eligible business tag from inter-ministerial group would be exempt from angel tax.

Second Notification of DIPP

On 23rd May,2017 the DIPP issued another notification in supersession of the one issued on 17th February, 2016 where in it redefined the word start-up as an entity would be considered as a start- up, up to 7 years from the date of its incorporation/registration and in case of start-ups in the biotechnology sector, the period shall be up to 10 years from the date of its incorporation. Other aspects of the definition remained the same.

Further, the notification stated that the tax benefits would be available to the entities incorporated after 1st April,2016 but before 1st April,2019 which again remained silent about the entities incorporated before 1st April,2016.

Action by tax officer on angel tax

The Assessing Officers started invoking section 56(2)(viib) in case of start-up which had raised genuine investments on the basis of their idea, through making additions by rejecting/modifying the valuation reports given by Chartered Accountants or Merchant Bankers as required by Rule 11UA(2)(b) stating that those are the abnormal valuations. The tax officers also chose to make such additions by alleging that subsequent actual revenues do not match up the numbers disclosed in the valuation workings carried on under Discounted Cash Flow (DCF) method.

Wide spread representations were made against such a regressive approach adopted by the tax authorities. As a response to that, CBDT brought out an instruction on 6th February,2018 as to not to take any coercive measure to recover the outstanding demand against these start-ups. Further, it asked to take necessary administrative steps for the cases which were pending before the Commissioner(Appeals), for its expeditious disposal.

However, there was no clarity as what would be the fate of such companies which would fit into the definition of the term start-up but were incorporated prior to 1st April 2016.

Current notification of DIPP

On 11th April 2018, the DIPP issued a notification bearing no. GSR 364(E) in supersession of its notification issued on 23rd May 2017, highlights of which are given as under:

- Certification for the purpose of section 80IAC – tax exemption:

DIPP recognised start up being a company or LLP[3] incorporated/registered after 1st April,2016 but before 1st April,2021 (substituted for 1st April,2019 by Finance Act,2018) may make an application in Form-1 along with the documents specified therein to obtain the certificate from Inter-Ministerial Board of Certification for the purpose of section 80-IAC in order to get 100% tax exemption for any 3 consecutive years out of 7 years beginning from the year in which start-up is incorporated.

- Approval for the purpose of exemption from angel tax

Companies who fulfil the below mentioned conditions, has to make an application in Form-2 for seeking approval to claim

[2] u/s 56(2)(viib), the power available to CBDT was only to notify the class of investors and not class of company receiving the investment. However, CBDT morphed it in a manner to suit 'start-up' receiving the money from any person as exempt from angel tax.

[3] Partnerships Firms are not covered here as section 80-IAC does not apply for Firms

exemption from the applicability of the section 56(2)(viib):

a) The aggregate amount of the paid up capital and the share premium after proposed issue should not exceed INR 10 crore.

b) The net worth of the investor who is subscribing the shares must be at least INR 2 crore on the last date of the last financial year or the average returned income of the investor must be at least INR 25 lakh in the last 3 financial years.

c) The start-up should also have obtained a valuation report from a merchant banker specifying the FMV of the shares in accordance with Rule 11UA of the Rules.

Advith Comments

Government has recognised the importance of start-up and has initiated schemes that will go a long way in nurturing good ideas in India. Provisions like angel tax are trying to take away the sheen from such good initiatives. It is nobody's argument that share issued at premiums that don't justify their real value should be allowed. However, it is very important for tax officers at the ground level to understand that not every share issue at premium is a mode of conversion of black money into legitimate money.

This provision [section 56(2)(viib)] was introduced into the tax law in the backdrop of 2G scam, where this route was used to pay money as kickbacks and hence having such a provision is absolutely essential to curtail those practices. However, loose and careless implementation of this provision is becoming a nightmare for various legitimate companies, which are raising funds by way of angel investment to sustain their business and are trying to build new age products and solutions, also creating employment opportunities in the country.

The current notification of DIPP is definitely a step in the right direction but it is unfortunately no where close to what start ups need. Instead of DIPP coming with a revised notification, it would have been better if CBDT would have come up with a better plan to handle assessments involving angel tax. For the following reasons, we believe that this notification is going to become more onerous on start-ups:

a) For the purpose of Rule 11UA of the Rules, a valuation report determining the FMV of shares can be obtained either from a **Merchant banker or from a Chartered Accountant**. But the current notification of DIPP mentions that the valuation report to be obtained from a **merchant banker only** which is over riding the provisions of the Income Tax Law. This, is not only going to increase the cost of compliance but is also legally inconsistent. This will add more confusions and could lead to litigation.

b) DIPP requires an application to be made for exemption from angel tax every time an investment is being raised. Typically, a start-up in its early stages raises investment at least twice in a particular year. This requirement would make it run behind only compliance and will also delay the actual raising of funds and will work counterproductive to the start-ups.

c) The start-ups are also required to prove the networth and last 2 years income of the persons investing in such companies. This requirement is completely baseless and harsh on start-ups. Tax authorities have all the powers to obtain any information about a person with the help of PAN. In that circumstance, putting the burden to determine investors responsibility on company raising funds is uncalled for. In cases where there is a suspicion of wrong doing, there are already provisions in the law which could have taken care of them (section 68). When start-ups are raising funds from people, asking to go and seek details of investors personal wealth would be asking too much and this could jeopardize the investment prospect itself.

d) It is also extremely unfortunate that there is no protection to a company which is incorporated prior to 1st April 2016 and has all the qualities of start-up but won't fit into the definition and hence it will continue to be at the rigours of angel tax and tax officers who believe that every issue of share at premium is a mode of conversion of illegitimate wealth!

As can be seen from the list above, the steps taken are neither comprehensive nor would solve the problems that start-ups are facing today. It is highly recommended that Government wakes up to the realities of raising funds by small but potentially sound companies. This should not become a case of well-intended law plagued by flawed execution.

<<This space has been intentionally left blank>>

About Advith Consulting

Advith Consulting is a multi-disciplinary consulting Firm offering range of services to cater clients with their professional needs. What makes Advith Consulting, a class apart is:

- Energetic, experienced and vibrant professionals driven by knowledge-centric client servicing practices.
- Fluidic organisation helping clients achieve their business goals by providing solutions to various requirements by seamlessly integrating all professional services.
- Belief in upholding the highest standards of business ethics with a total commitment to quality.
- Adequately backed by a committed team of employees, talent and expertise in multiple areas, which is the key for timely deliverables.

Reach us at:

Advith Consulting LLP
No. 72/1, 2nd Floor, Jnanodaya School Road
Shankarapark, Shankarpuram, Bangalore 560 004
Contact: 080 22426484;
email: info@advithconsulting.in
Visit us at: www.advithconsulting.in