DECRYPTING TAXATION OF STARTUPS

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BACKGROUND – INDIA SCENARIO

We all are very familiar with terms like Unicorns, Founders, Funding, Valuation, Due Diligence, Seed round, Pre-Series, Boot Strapping etc. Yes, these are terms all revolving around the Startups which have created an uproar in the business world. Every now and then there is some news on the happenings in the Startups world. Millennials are in the forefront of innovation and comprise a huge part of the Startup as founders, idea creators, content creators, work force etc.

To give momentum to and build a strong Startups ecosystem, our PM Shri Narendra Modi had announced the flagship Startups India Initiative. In order to boost entrepreneurship, employment, innovation under the said initiative, the Government of India (GOI), introduced various benefits and facilities for the Startups. Benefits under Income tax provisions being one of them.

Startups is an Idea where the founders identify problems and try and bring solution to it in the most effective and efficient manner. They are entrepreneurs who bring in innovations and solutions that have never been done before or if done earlier are now more efficient thereby leading to generation of employment and wealth creation.

Startups usually have brilliant ideas for problem solving but generally are short of funds to the put those ideas into action. People with wealth who have a strong belief on the success of those ideas jump in to provide the much-needed funds as an Angel and are therefore called as Angel Investors. The concept of Angel Taxation came into existence when notices for additions under provisions of Sec 56(2)(viib) were issued to these Startups. There was a huge hue and cry on Angel taxation and therefore urgently required an urgent step in by the government. This resulted in some reliefs being extended to the eligible Start-ups. The issue of Angel tax has been dealt with in detail ahead.

In this article, I have tried to cover the tax provisions impacting various categories of people associated with Startups. It is divided into the following

a. Tax provisions affecting Startups entities

b. Tax provisions affecting employees of Startups

c. Other Provisions

A. Tax provisions affecting the Startups entities

1. Tax Holiday - Deduction of 100% Profits – Sec 80-IAC

In times when the government was withdrawing or giving sunsets to profit linked investments, the government introduced Sec 80-IAC to encourage and incentivise Startups. Tax Provisions for deduction of profits to eligible Startups u/s. 80-IAC are as follows:

Particulars	Provisions of Sec 80-IAC
Eligible Startups	i. Company / LLP engaged in eligible business ii. Incorporated on or after 1st April 2016 but before 1st April, 2024. iii. Turnover does not exceed Rs. 100 crores in the year in which deduction is claimed (Turnover can exceed Rs. 100 crores before or after the said years out of the 10 years) iv. Entity holds a certificate of eligible Start-up from the Inter-Ministerial Board of Certification of Department for Promotion of Industry and Internal Trade (DPIIT) **Restrictions** i. Entity is not formed up by splitting up or reconstruction of business already in existence ii. Entity is not formed by plant or machinery previously used Exception: a. Plant & machinery used outside India, was not used in India before its installation b. Plant & machinery was imported to India c. Prior to its installation, no depreciation has been claimed and allowed under the Income tax Act, 1961
Eligible Business	Eligible Startups engaged in i. Innovation ii. Development iii. Improvement Of Products or process or services iv. Scalable business with high potential of employment generation or wealth creation
Deduction amount	100% of Profits derived from eligible business
No. of years	Any 3 **consecutive** years out of 10 years beginning from the year of incorporation (at the option of the Assessee)
Form for claim	For claiming the deduction of 100% profits, the eligible Startup is required to furnish Form 10CCB duly signed and verified by a Chartered Accountant 1 month before filing the return of income.

Conditions prescribed by the DPIIT vide Notification G.S.R. 127(E) dated 19th February, 2019 to recognise the eligible entity as a Startups are as given below

Particulars	Conditions prescribed by DPIIT
Entity to be considered to be a Startups – (Conditions for availing registration to be eligible for 80-IAC deduction)	i. Private Limited Company / Registered partnership Firm / LLP ii. Will be eligible only upto 10 years from the year of incorporation / registration iii. Turnover to not exceed Rs. 100 crores in the given 10 years from incorporation / registration iv. Engaged in Innovation, development, Improvement of Process or products or services or is a scalable business model with employment generation or wealth creation <u>To get certificate of an eligible Startups for claiming deduction of profits u/s. 80-IAC, an eligible Startups is required to file Form 1 with the Inter-Ministerial Board of DPIIT along with the prescribed documents. The Board shall verify, make enquires and if deems fit, grant approval.</u>
Conditions for claiming exemption u/s. 56(2)(viib)	i. Certificate of Eligible Startup Inter Ministerial Board of DPIIT ii. Aggregate amount of paid up share capital and share premium does not exceed Rs. 25 crores after issue of shares **Exceptions – Following will not be considered to determine the above limit** i. Shares issued to Non resident ii. Shares issued to venture Capital company or venture capital fund iii. Shares issued to listed company whose net worth > 100 crores or Turnover > 250 crores in preceding year to year in which shares are issued. <u>For claim of relaxation from the provisions of Sec 56(2)(viib), a self-certified declaration is required to be filed in Form-2 with DPIIT, which, in turn, shall be forwarded to CBDT.</u>
Restrictions	The start-up shall not invest the amount received from issue of shares in the following: I. Land or building being residential house other than that used for the purposes of renting. ii. Land or building not being a residential house other than that occupied by start-up for its business or renting. iii. Loans and advances, if start-up isn't engaged in ordinary business of lending of money. iv. Capital contribution made to any other entity v. Shares and securities vi. Motor vehicle, aircraft, yacht or any other mode of transport, if the cost of such an asset exceeds Rs. 10 lakhs. vii. Jewellery viii. Archaeological collections, drawings, paintings, sculptures, any work of art or bullion ix. Any other capital asset. However, the above conditions are not applicable in case start-up holds the above assets as stock-in-trade, in its ordinary course of business. <u>Startups seeking the Angel tax exemption can't undertake ordinary transactions such as salary advances, stock M&A, creation of a subsidiary, or contribution to an ESOP trust. These restrictions shall make it impossible for start-ups to scale or compete globally.</u>

2. Provisions of Sec 56(2)(viib) – relaxation for eligible Startups

A common method to transfer funds between unconnected persons without any income-tax implications was to infuse funds into a closely held company at a huge premium. This resulted in generation and circulation of unaccounted money and money laundering through issue of shares, and in order to prevent the same the government introduced the provisions of Sec 56(2)(viib).

The intent of the government by bringing the said provisions on statue is true and correct, however problems commenced when the tax department started issuing notices to Startups who received huge amounts towards premium. In the Starts ups, investors generally do funding even before the Startups starts earning revenue. The premiums are high due to the belief of the investor on the success of the idea of the Startup. The said high premiums cannot be justified by applying bookish valuation methods based on the book value or DCF method. The Assessing Officers failed to understand these huge valuations and simply going by prescribed method had started making huge additions. Hence the terminology of Angel taxation emerged and became famous due to these reasons. The government then granted relief to eligible Startups from the applicability of provisions of Angel taxation.

Following is the provision and the requirement of Sec 56(2)(viib)

Particulars	**Provisions of Sec 56(2)(viib)**
Applies to	All persons, Resident as well as Non resident **Non residents were earlier not covered within the ambit of these provisions, however the Finance Act 2023 brought in an amendment to cover the non residents as well from 1st April, 2023** <u>Not Applicable to</u> i. Venture Capital (VC) undertaking receiving the consideration from a VC company or a VC fund registered with SEBI or AIF I & AIF II regulated by SEBI or IFSC Authority Act or IFSC regulations ii. Eligible Startups who have obtained a certificate from the Inter-Ministerial Board of DPIIT and whose iii. Persons notified by the Central Government. (Certain class of persons of the specified countries have been given exemption from the applicability of provisions of Sec 56(2)(viib) - Refer Notification S.O. 2274(E) [NO. 29/2023/F. NO. 370142/9/2023-TPL (PART-I)] DATED 24-5-2023)
Transaction	Issue of shares by a Company not being a company in which public are substantially interested and aggregate amount of paid up share capital and share premium does not exceed Rs. 25 crores after issue of shares.
Taxable amount	Consideration amount in excess of FMV of shares
Trigger point	Consideration amount is received in excess of FMV of shares where issue price exceeds face value

Particulars	Provisions of Sec 56(2)(viib)
Determination of FMV	FMV shall be as per i. Methods prescribed as per Rule 11UA read with Rule 11U (NAV method or DCF method) **OR** ii. Price substantiated by the company to the satisfaction of the Assessing officer Proposed changes open for public 1. For receipt from non-residents, 5 new internationally accepted methods of valuation have been proposed and have been kept open for public comments– i. Comparable Company Multiple Method ii. Probability Weighted Expected Return Method iii. Option Pricing Method iv. Milestone Analysis Method v. Replacement Cost Methods Representations have been made to extend the applicability of the said valuation methods to investments from residents as well 2. On issue of shares to non-resident entity notified by the Government or Venture Capital Fund or Funds from specified funds, price at which shares are issued to them shall be considered as FMV subject to fulfilment of the following conditions a. FMV does not exceed aggregate consideration received from them b. Consideration is received within 90 days from the date of the issue 3. Valuation from Merchant Banker should not be more than 90 days prior to the date of issue of shares 4. Safe harbour of 10% variation in value to be provided for forex fluctuation, economic indicators etc.
Valuation Report to be taken from	Valuation report to be procured from the Merchant Banker

The Startups in receipt of the certificate of recognised and eligible Start-up's from the Inter-Ministerial Board of DPIIT are not subject to provisions of Sec 56(2)(viib). However the Startups though engaged in the eligible business of innovative product or process or scalable business having potential of employment generation or wealth creation, if do not fulfil other criteria's as stated by the DPIIT, shall not be able to safeguard themselves from the rigors of provisions of Sec 56(2)(viib).

Extending the applicability of the provisions of sec 56(2)(viib) to Non residents

Finance Act, 2023 brought in an amendment by making the provisions of Sec 56(2)(viib) applicable to Non-residents. The Memorandum stated that the objective of the amendment is to widen the tax base by rationalising the tax provisions in order to eliminate the possibility of tax avoidance by extending the applicability to any person irrespective of the residential status. However Inbound Investments by non-residents were already being regulated under the provisions of FEMA and the amounts towards receipt of shares were being routed through banking channels. Then one fails to understand as to why was there a need to bring the non-residents within the ambit of provisions of Sec 56(2)(viib).

1. **Valuation under FEMA vis a vis Income Tax Act –** Under FEMA, presently the inbound investments on issue of shares are being accepted at a valuation determined by the internationally accepted principles of valuation. FMV determined as per FEMA should be the minimum value for which shares sought to be issued which means that shares can be issued at the determined FMV or any higher price. Unlike FEMA provisions, under the Income Tax Act, the share price should not exceed the FMV as per the prescribed method. Valuation is subjective and not an exact science and the price paid for an asset (i.e., share) is often a result of a negotiation process between the buyer and seller. Therefore, the valuation methodology adopted could range anywhere from being a simple book value-based approach to other complex methods. A valuation method aligning valuations under both the laws will have to be worked out and kept in mind by the company while issuing shares to non-residents. The introduction of the new 5 methods of valuation having international and wide acceptability seems to be a move by the government in the direction of aligning valuations under both laws. However given the past experience, the track record of how the tax department functions, the complexities and the perspective of the founder and the investor involved whiling sitting on the table to negotiate, the understanding of the tax authorities on a case to case basis and applicability by them of the newly proposed methods, it does not appear that Startups could sail through easily without going through the hassle. Time will only tell what lies ahead.

2. **Impact on FDI –** India is one of the fastest growing economy and has the 3rd largest Startups eco system. Even today major investments come from foreign sources. Generation of funding from the non-resident into the Indian Startups eco system will give a push and momentum to both the Startups well as the Indian Economy. However non-resident investors could resist from making investments in Indian Startups due to uncertainties on account of tax provisions and probable litigations that may arise by including them in the ambit of Sec 56(2)(viib). This amendment could result as a hindrance to attract foreign money. Many entrepreneurs are even accelerating their flip to an overseas jurisdiction due to this change. Therefore, the government will have to try and achieve a balance between the non-resident investments and tax evasion provisions introduced with the intent of plugging money laundering and unaccounted use of money.

3. **No relief from applicability of provisions of Sec 68**

   As per the provisions of Sec 68, if a sum is found credited in the books of an Assessee and the Assessee offers no explanation or the Assessing officer is not satisfied with the explanation offered, then the sum so credited shall be deemed to be the income of the Assessee. Even though an eligible Startups may have relief from the applicability of provisions of Sec 56(2)(viib), under the provisions of Sec 68, the Startups entity shall still be required to prove the genuineness, creditworthiness and the identity of the person making the investments in the Startups. Relief from applicability of provisions of Sec 68 has been granted only to selected category of Startups i.e. sum credited in the books of Venture Capital Company or Venture Capital Fund.

4. **Carried forward and set off loss under Sec 79**

   As per the provisions of Sec 79, business loss to a Company can be allowed to be carried forward and set off only in case when the shareholders holding not less than 51% of the shares in the year of incurrence of loss are the shareholders in the year of carried forward and set off. These provisions are crucial for a Startups as it incurs losses in the initial years of operations. Allowing carry forward and set-off of losses reduces the taxation burden on a start-up in the initial years of profits and results in a positive impact on its cash flows. However due to the peculiarity of constant changes in the Investors and the changes in shareholding % of the Promoters / Investors in a Startups, the said section becomes inapplicable and the Startups are unable to carry forward and set off losses incurred in its initial years. In order to facilitate the ease of doing business and promote Startup ecosystem, the government has rationalised the provisions of Sec 79 for Startups.

An **<u>eligible Startup Company u 80-IAC</u>** is allowed to carry forward and set off their past year losses, if either of two conditions are satisfied:

i. At least 51% of the voting power is beneficially held by the same persons on two relevant dates as follows:
i. the last day of the previous year in which such loss was incurred; and
ii. the last day of the previous year in which the loss brought forward has to be set off.

<u>OR</u>

ii. all the shareholders holding shares carrying the voting power on the last day of the financial year in which loss was incurred should continue to hold those shares on the last day of the financial year in which the loss brought forward are to be set off, and losses pertain to initial 10 years from the date of its incorporation.

<u>A Startup who is not an eligible Startup as per Sec 80-IAC shall still be required to fulfil condition (a) above.</u>
However, even after the amendment, many Eligible Startups may get hit by section 79 limitation, because of two reasons:

a. With passing time, the shareholding of Promoters/initial shareholders may reduce resulting in a reduction of voting power by more than 51%, as start-ups need funding for running its business operations

b. many PE investors generally consider the time frame of 3-5 years for exit from a start-up
In such a scenario, a start-up may not be able to fulfil both the conditions and hence, may not be able to carry forward and set-off past years' losses.

5. Eligible Startups – 80-IAC not eligible for concessional tax rate under Sec 115BAA and Sec 115BAB

a. Sec 115AA – Domestic companies have been given an option to pay tax at concessional rate of 22% subject to the condition that it shall not avail certain benefits / exemptions / deductions. For companies opting for concessional rate, the effective tax rate works out to 25.17% inclusive of Surcharge and Cess.

b. Sec 115BAB – New domestic companies incorporated on or after 1st October, 2019 and engaged in the business of manufacturing goods have been given an option to pay tax at concessional rate of 15% subject to the condition that it shall not avail certain benefits / exemptions / deductions. For newly incorporated manufacturing companies opting for the said concessional rate, the effective tax rate works out to 17.16% inclusive of Surcharge and Cess.

Companies opting for concessional rates in the above mentioned Sections cannot claim deduction under the provisions of section 10AA or section 32(1)(iia) or section 32AD or section 33AB or section 33ABA or sub-clause (ii) or sub-clause (iia) or sub-clause (iii) of sub-section (1) or sub-section (2AA) or sub-section (2AB) of section 35 or section 35AD or section 35CCC or section 35CCD or under any provisions of Chapter VI-A other than the provisions of section 80JJAA or section 80M.

Since Sec 80-IAC is not covered under the exception of deductions under Chapter VIA, an eligible Startup eligible under Section 80-IAC and claiming deduction of 100% profits for any 3 consecutive years out of 10 years from the date of incorporation, shall not be eligible for concessional rate of taxation.

B. Tax provisions affecting the Startups employees

Deferment of tax on ESOPs of employees of eligible Startups – Sec 17(2)(vi)

In order to retain talented employees, it is important to compensate them thoroughly. In case of Startups, cash flows and cash liquidity are always a concern. There is always a cash crunch due to good amount of cash burnouts in the initial years. In such situations, the Startups offer Employee Stock Option Plans (ESOPs) to its employee. ESOPs are options given to employees to subscribe to shares of the Startup companies at a discounted rate on fulfilment of certain conditions. It is compensation given to them in kind and hence are in the nature of perquisites. The employer is required to deduct and pay tax on the perquisites amount (i.e. difference of the fair value in the as on the date of the exercise and discounted exercise price) in the year of exercise. However due to cash liquidity issues in Startups, the government has given a concession to eligible Startups to defer to deduct and pay tax on perquisites within 14 day of the earliest of the following events

i. After the expiry of 48 months from the end of the relevant assessment year;
OR
ii. from the date of the sale of such specified security or sweat equity share by the Assessee; **OR**
iii. from the date of the Assessee ceasing to be the employee of the entity

C. Other Tax provisions

Capital Gain Exemption u/s. 54GB

The provisions of exemption u/s. 54GB are as given below

Particulars	Provisions of Sec 54GB
Applicable to	An individual or Hindu undivided family
Capital Gain arising from	Transfer of Long-Term capital Asset being a residential property (a house or a Plot of land)
Exemption available when	Net consideration is invested in the Eligible Startups u/s 80-IAC and the Eligible Startups has utilised the amount for purchase of new asset within 1 year from the date of subscription by the Assessee.
Amount of Exemption	i. If net consideration > cost of the new assets then, Cost of the new asset *Capital Gain / Net ale consideration ii. If net consideration < cost of the new asset, whole of the Capital Gains
New Asset means	New Plant and Machinery but does not include i. any machinery or plant which, was earlier used by any other person – within or outside India ii. any machinery or plant installed in any office premises or any residential accommodation or a guest house; iii. any office appliances iv. Computers or computer software; other than a technology-driven start-up certified by the Inter-Ministerial Board of Certification notified by the Central Government in the Official Gazette v. any vehicle;

Particulars	Provisions of Sec 54GB
New Asset means	v. any vehicle; vi. any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and gains of business or profession" of any previous year
Date up to which investments can be made	31st March 2023 (extended by CBDT circular no.1 / 2023 dated 6th January, 2023 from earlier date of 31st March 2022)
Lock in Period	Investor - Equity shares of the Eligible Startup to be held for 5 years from the date of investments Eligible Startup – to hold new asset for 5 years from the date of acquisition
Consequences of violation of Lock in Period	In case new asset is transferred, exemption claimed shall be deemed to be income of the year in which new asset is transferred and shall be subject to Capital Gain tax. In case of sale equity shares, exemption claimed shall be deemed to be income of the year and shall be taxed as Capital Gain along with Capital gain on sale of shares in the year of sale.

Conclusion

Starts ups have their presence in almost every sector of the economy. They are leaving no stones unturned. They are bringing in innovation and bringing in new technology to make living easy and simpler. Right from inception, the number of Startups have grown multi fold and are still multiplying. With the growth of Startups, the economy grows too. Hence the government should try, adopt and creative a conducive environment for Startups to operate. It needs to be appreciated that a lot of ease and benefits have been extended to the Startups by the government as and when it has been realising the same. Still the teething issues in compliance, procedures, tax laws or any other applicable laws faced by them should be immediately addressed to. Tax laws should be made more simpler to adhere to. Startups function differently from the usual businesses. Its uniqueness and nitty gritty needs to be understood before blindly applying tax provisions to safeguard genuine Startups from unnecessary hardships.

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