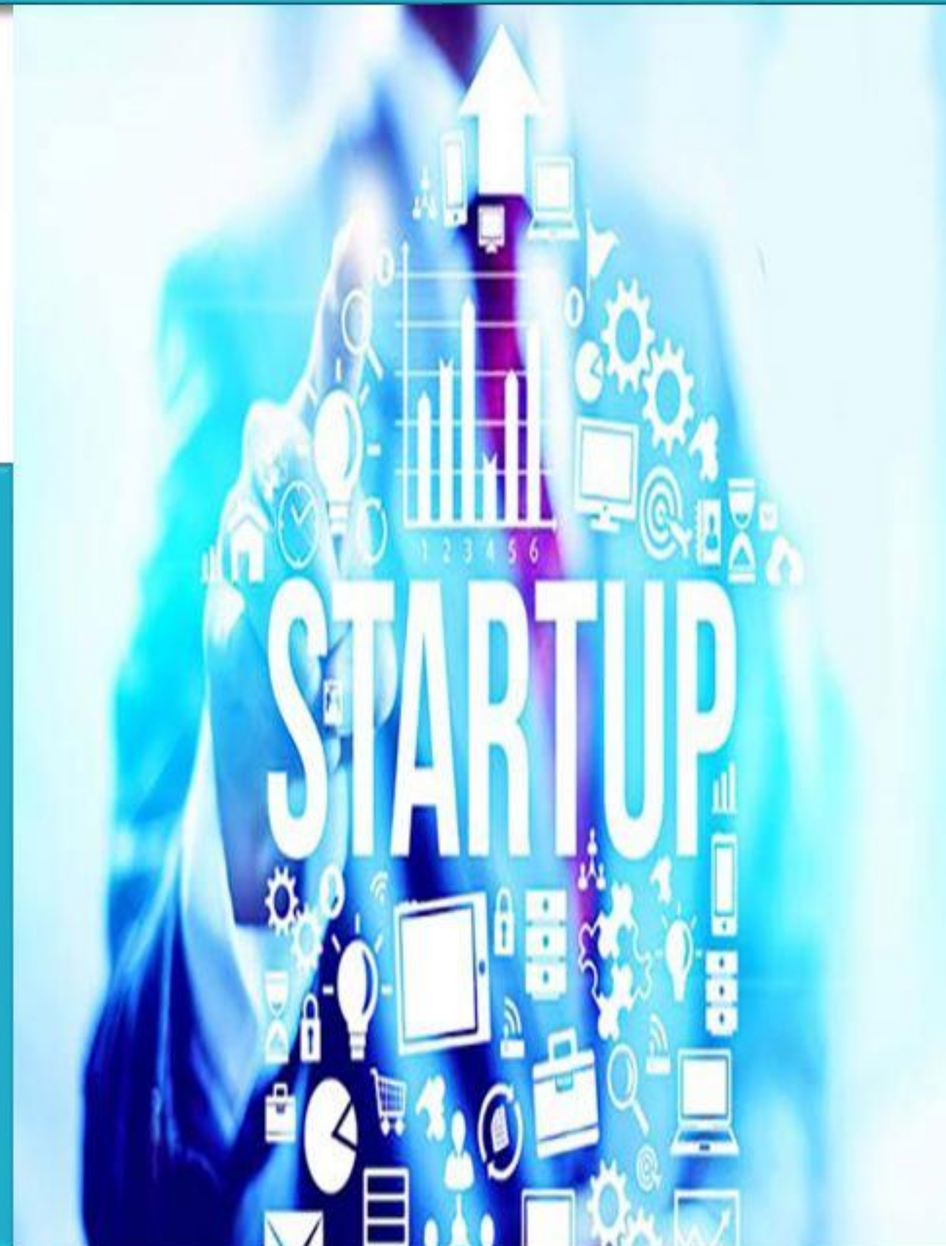
Taxation of Startups including Share Premium



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What is a start-up?

As per the Department for Promotion of Industry and Internal Trade ("DPITT") Notification dated 19th February, 2019, a Startup has been defined as follows,

(a) An entity shall be considered as a Startup:

i. Upto a period of ten years from the date of incorporation/ registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India

What is a start-up?

ii. Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded one hundred crore rupees.

iii. Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

Provided that an entity formed by splitting up or reconstruction of an existing business shall not be considered a 'Startup'.

What is a start-up?

- **Explanation:**

ceases to be a Startup

- on completion of ten years from the date of its incorporation/ registration or
- if its turnover for any previous year exceeds **100Cr**.

"Act" means the Income-tax Act, 1961

"Board" means the Inter-Ministerial Board of Certification

"CBDT" means Central Board of Direct Taxes

"DPIIT" means Department for Promotion of Industry and Internal Trade

What is 'Innovation, development or improvement of products or processes or services'?

- In layman terms, an innovation can mean 'a new idea, creative thoughts, new imaginations in form of device or method'.

- Similarly, development of innovative products or processes or services is often viewed as the application of better solutions that meet new requirements, unarticulated needs, or existing market needs.

Some **Unicorns** in Indian Startup context

1. **OYO ROOMS**

   OYO is a hotel network that offers standardized and hassle-free stay experiences. OYO revolutionized the fragmented and legacy-driven budget hospitality space in India by allowing standardization of services, amenities and in-room experience, and its proprietary apps for inventory-management, room-service, revenue-management, and customer-relationship management.

Some **Unicorns** in Indian Startup context

2. **PAYTM**

   Paytm is India's largest mobile commerce platform. Paytm started by offering mobile recharge and utility bill payments and today it offers a full marketplace to consumers on its mobile apps. Paytm has over 20mn registered users. In a short span of time Paytm has scaled to more than 15 Million orders per month.

Some **Unicorns** in Indian Startup context

3. **<u>Zomato</u>**

   Zomato is a restaurant search and discovery app, providing in-depth information for over 1 million restaurants across 23 countries. Zomato is used by consumers globally to discover, rate, and reviews of restaurants, as well as create their own personal networks of fellow food enthusiasts for trusted recommendations.

Some **Unicorns** in Indian Startup context

4. <u>OLA CABS</u>

Ola's unique selling point lies in understanding the local dynamics and creating solutions specifically for the Indian market conditions. Launching e-rickshaws, auto-rickshaws, Ola Micro and shared mobility solutions like Ola Share and Shuttle are few of the recent examples in this direction which has hit the market very hard. Given its 'Made for India' focus, it has a definitive advantage of innovation and hyper-local execution.

Some **Unicorns** in Indian Startup context

Some more successful Startups at a glance:

- Flipkart
- Shopclues
- Swiggy
- Make My Trip
- Practo
- Red Bus

How to register a Startup?

"2. The process of recognition of an eligible entity as Startup shall be as under: —

- make an online application over the mobile app or portal set up by the DPIIT.
- *The application shall be accompanied by—*
  - a copy of Certificate of Incorporation or Registration.
  - a write-up about the nature of business highlighting how it is working towards innovation, development or improvement of products or processes or services, or its scalability in terms of employment generation or wealth creation.
- The **DPIIT may**, after calling for such documents or information and making such enquiries, as it may deem fit, accept and **recognize the entity as Startup** or reject the application by providing reasons.

Certification for Sec.80IAC of the Act

- A Startup being a ***private limited company or limited liability partnership***, which fulfils the conditions specified in sub-clause (i) and sub-clause (ii) of the Explanation to section 80-IAC of the Act, may **make an application to** the **Board in Form-1** for obtaining certificate for the purposes of sec.80IAC of the Act.
- **Board** may, after calling for such documents or information and making such enquires, as it **may** deem fit, -
  - **grant** the certificate referred in sec.80IAC(ii)(c) of Explanation **(or)**
  - **reject** the application by providing reasons

Sec.80IAC of the Act

*(1) Where the gross total income of an assessee, being an eligible start-up, includes any **profits and gains** derived **from eligible business**, there shall, in accordance with and subject to the provisions of this section, **be allowed**, in computing the total income of the assessee, **a deduction** of an amount **equal to one hundred per cent of the profits** and gains derived from such business **for three consecutive assessment years**.*

- *To be claimed for any three consecutive assessment years out of [seven] years from the year of incorporation.*

(probably this may become 10 Years)

Sec.80IAC of the Act

Conditions for Sec. 80IAC

- It is not formed by splitting up, or the reconstruction, of a business already in existence.
  (Provided this condition shall not apply in case of Startup formed as referred in sec. 33B of the Act)

- It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

Sec.80IAC of the Act

Exceptions :

- Imported P&M
  - Which was not used in India.
  - Imported into India.
  - No depreciation claimed on such P&M in India so far.

- Even previously used P&M is allowed upto 20 per cent of the total value of P&M used in the business.

Sec.80IAC of the Act

"eligible business" *means a business carried out by an eligible start-up engaged in innovation, development or improvement of products or processes or services or a scalable business model with a high potential of employment generation or wealth creation;*

"eligible start-up" means a company or a LLP engaged in eligible business which fulfils the following conditions, namely:—

a) Incorporated on or after 1-04-2016 but before 01-4-2021.
b) Turnover does not exceed INR **25 crores** in the previous year for which deduction is claimed **and**
c) It holds a certificate of eligible business from **IMB**.

Sec.80IAC of the Act

Section 80IAC (4)

The provisions of sub-section (5) and sub-sections (7) to (11) of section 80-IA shall apply to the start-ups for the purpose of allowing deductions under sub-section (1).

- **80IA(5)-** Eligible business to be treated as only source of income of the assessee during the tax holiday period.
- **80IA(7)-** Separate accounts to be maintained for eligible business and get audited.
- **80IA(8)-** Inter unit transfers from eligible business to non eligible business and vice-versa.- as per market value (ALP)

Sec.80IAC of the Act

- **80IA(9)-** Deduction shall be restricted to the profits and gains of the eligible business
- **80IA(10)-** Closely connected entities- transactions should not result in more than ordinary profits.
- **80IA(11)-** Certain class of Industrial undertaking/enterprise- be kept out of the tax holiday ambit by Central Government.

Revocation:

As per clause 8(1)&(2) of Notification dt. 19-02-2019, if the certificate has been obtained on the basis of false information, IMB reserves the right to revoke such certificate or approval and it shall be deemed that such certificate was never to have been issued or granted by IMB.

Issues

- A partnership firm though eligible to be treated as Startup cannot claim 80IAC

- Inconsistency between Notification and 80IAC
  - Period 10 years Vs 7 years
  - Turnover threshold 100Cr Vs 25 CR

- Most of the Startups incur losses even up to 10 Years hence this deduction may not really help.

- Three consecutive years may create a problem as all the 3 years may not yield profits continuously.

Case Law

Splitting up or reconstruction:

- *The words and terms 'splitting up' or 'reconstruction' used in clause (ii) to sub-section (4) to section 10AA reflect a deliberate forethought in the choice of words. Plain as well as intelligible legislative mandate is not to disqualify existing assessee in the same line of business, albeit the unit set up should not be by way of 'splitting up' or 'reconstruction'. Any other interpretation would defeat the purpose and objective behind section 10AA which was to encourage setting up of new units in the SEZ, and thereby create and add jobs, contribute to growth of the economy and earn foreign exchange.-* **Macquarie Global Services (P.) Ltd. [2019] 102 taxmann.com 272 (Delhi-HC)**
- Bar as provided under section 80-IA(3) is to be considered only for first year of claim for deduction under section 80-IA- **Tata Communications Internet Services Ltd [2012] 17 taxmann.com 241 (Delhi-HC)**

Case Law

Splitting up or reconstruction:

- Manufacturing of a new product with a new technology at an existing place after taking fresh approvals from SEZ authorities does not amount to splitting up or reconstruction of an existing business so as to deny exemption claimed under section 10B - ***Metal Alloys Corporation [2015] 59 taxmann.com 370 (Rajkot - Trib.)***

- Where assessee claimed deduction u/s 80-IB in accounts of his two proprietary concerns 'Y' and 'S' and AO disallowed claim on plea that said concerns had been formed by assessee by splitting up or reconstruction of business of his other concern 'J', since transactions with 'Y' and 'S' had been made at market value of such goods, assessee was entitled to deduction- ***Jagdishprasad M. Joshi [2017] 84 taxmann.com 308 (Bombay- HC)***

Case Law

Splitting up or reconstruction:

- A mere reconstitution of partnership firm does not amount to splitting up or reconstruction of partnership business already in existence so as to deny exemption under section 10B- ***Arts Beauty Exports [2012] 28 taxmann.com 16 (Delhi- HC)***

- where assessee was in software technology park and registered as STPI in 2002 and further assessee was not formed by splitting up or reconstruction of business already in existence, mere fact that assessee was in existence since 1999, i.e., prior to date of registration on 27-3-2002, would not disentitle assessee from claiming benefit under section 10A- ***Nagesh Chundur [2013] 39 taxmann.com 190 (Madras- HC)***

Case Law

Splitting up or reconstruction:

- *It is necessary that it should not be formed by transfer of building or machinery. The restriction or denial of benefit arises not by transfer of building or material to the new company but from the fact that it should not be formed by such transfer. That is the key to the interpretation. The formation should not be by such transfer.-* ***Bajaj Tempo Ltd [1992] 196 ITR 188 (SC)***

Angel Tax

Introduction:

- This provision is meant to check black money flows into capital of a company.

- However of late genuine Startups have come under scanner and huge demands have been raised.

- After strong representations made by the stakeholders, Govt of India responded to the issue through a Notification dt. 19-02-2019 issued by DPIIT providing exemptions with some conditions.

- No exemptions were provided for completed assessments of Startups where sizeable demands have been raised.

- It is therefore essential to analyze the import of this Notification dt.19-02-2019.

Section 56(2)(viib) of the Act

*(viib) where a company, **not being a company in which the public are substantially interested**, receives, in any previous year, from any person being a resident, **any consideration** for issue of shares **that exceeds the face value** of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:*

Provided that this clause shall not apply where the consideration for issue of shares is received—

(*i*) by a venture capital undertaking from a venture capital company or a venture capital fund; or

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

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

Conditions for a Startup to become eligible **for exemption** under section 56(2)(viib) as per Para 4 of Notification dt. 19-02-2019

- Recognized by DPIIT.
- Paid up share capital + share premium, does not exceed, **25 crore** rupees.
- *The above threshold will not include investments from*
    - Non Resident, venture capital company, Venture capital fund or a listed company whose net-worth is more than 100Cr or TO>250Cr at the year end/ for the financial year respectively preceding the year of investment

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

- Shall not invest in the following assets for 7 years from the end of the year in which shares are issued at premium
    - Building or land appurtenant thereto, being a residential house or not, other than that used for its business purposes, for renting or as stock in trade.
    - Loans and advances, provided it is not a part of its business operation.
    - Capital contribution in other entities or portfolio investments.
    - Any Vehicle, Aircraft, Yacht etc. if the cost exceeds Rs.10 Lakhs other than that used for business purposes or as stock in trade.
    - Jewellery other than used as stock in trade.
    - Other assets specified in sub clauses (iv) to (ix) of clause (d) of Explanation to sec.56(2)(vii) of the Act.

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

- An eligible Startup which satisfies the conditions specified in Para 4 of the Notification shall file a signed declaration in Form 2 to DIPP.
- On receipt of such declaration, the DPIIT shall forward the same to CBDT.

Scope of this Notification/ Exemption:

- Any eligible Startup can avail this exemption after fulfilling the conditions specified in Para 4.
- This Notification will be **applicable retrospectively in respect of shares issued by the Startup from the date of its incorporation**, except in such cases where additions u/s 56(2)(viib) of the Act have been made in assessment orders which were passed before the date of issue of Notification.

Revocation:

In case the Startup invests in violation of the conditions of Para 4(iii) of the Notification before the end of 7 years from the end of the year in which shares are issued at premium, the exemption provided u/s 56(2)(viib) shall be revoked with retrospective effect.

Angel Tax
Exemption for sec. 56(2)(viib) of the Act

Analysis, issues and concerns

- Any investment in a Startup is for the idea that is being groomed into a business plan. Hence valuation is totally on the basis of future of such idea.

- NRIs are always out of the angel tax ambit even in the past hence there is nothing new on this count.

- There is no exemption given in respect of Sec.68 in the hands of Startup and it is only an exemption for Sec. 56(2)(viib).

- A very undesirable restriction is to deprive a Startup to scale up by setting up a subsidiary abroad (or) in India in line with its business plan.

Angel Tax
Exemption for sec. 56(2)(viib) of the Act

Analysis, issues and concerns

- Category –II AIFs are kept outside the exemption ambit of Notification while maximum number of VC funds are set up as CAT-II AIF funds which invest into Startups.

- Investments to be made by resident investors in the advanced stage will be hit by angel tax provisions once the threshold of Rs.25 Crores is crossed.

- As per the conditions, a Startup would not be allowed to invest in MF or FDs in case if it is making profits and accumulate some surplus funds.

- Increase of turnover and status period as Startup brought in by Notification should also be brought in as amendment in Sec. 80IAC. Otherwise this inconsistency creates practical problems.

Angel Tax
Exemption for sec. 56(2)(viib) of the Act

Analysis, issues and concerns

- Exemption for Sec. 56(2)(viib) will be granted by DPIIT and not by IMB as in the past.

- In the present Notification investor eligibility criteria for availing angel tax exemption has been dispensed.

- In case conditions are violated it is provided for retrospective withdrawal of exemption availed. It is interesting to note how the Revenue will bring such receipts to tax as there is no specific provision in IT Act to tax such receipts on account of violation of conditions.

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

Analysis, issues and concerns

- Resident HNIs are not covered by the provisions of exemptions in the Notification. Now in the present economy HNIs constitute a very important funding source which needs to be addressed.

- This Notification will be **applicable retrospectively in respect of shares issued by the Startup from the date of its incorporation** , except in such cases where additions u/s 56(2)(viib) of the Act have been made in assessment orders which were passed before the date of issue of Notification.

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

Pre-Notification disputes:

- Provisions of sec. 56(2)(viib) r.w.r 11UA(2) provide that any share premium received along with the nominal value which is in excess of fair market value (FMV) of the shares should be brought to tax in the hands of the company.

- Rule 11UA(2) provides option of two methods for valuation i.e NAV or DCF method which is to be valued by a merchant banker.

- It is often prevalent that DCF method is used by the merchant bankers in technology and innovation companies. That is how an investor is ready to invest appreciating the future value of the company. This established approach which is market driven cannot put the company receiving the investment to disadvantage.

Angel Tax

Exemption for sec. 56(2)(viib) of the Act

Pre-Notification disputes:

- In the recent past prior to Notification dt. 19-02-2019 tax authorities have applied these provisions in the hands of various Startups and rejected the valuations which resulted in adjustments and tax demands.

- It is therefore critical to analyze the recent case law of Hon'ble High Courts & Hon'ble ITAT and draw the import of the ratio of the same.

Angel Tax
Case Law

- Where valuation is done on basis of Discounted Cash Flow (DCF) method only depending on information by management of assessee, since assessee could not conclusively establish that such projection/estimation done by its management was on a scientific basis, Assessing Officer was justified in rejecting valuation done by Chartered Accountant. However it was held that AO should apply only DCF method for conducting valuation afresh ***Innoviti Payment Solutions (P.) Ltd. [2019] 102 taxmann.com 59 (Bangalore - Trib.)***

- Where assessee company determined Fair Market Value of shares issued at premium on basis of Discount Cash Flow method in accordance with rule 11UA(2)(b) read with section 56(2)(viib) and valuation report was prepared as per guidelines given by ICAI and no fault was found in same. Assessing Officer was unjustified in changing method of valuation of shares at premium to Net Asset Value method- ***Rameshwaram Strong Glass (P.) Ltd [2018] 96 taxmann.com 542 (Jaipur - Trib.)***

Angel Tax
Case Law

- The AO is undoubtedly entitled to scrutinise the valuation report and determine a fresh valuation from an independent valuer to confront the petitioner. However, the basis has to be the DCF Method and it is <u>not open to him to change the method of valuation</u> which has been opted for by the assessee. ***Vodafone M-Pesa Ltd [2018] 92 taxmann.com 73 (Bombay)***

- Where assessee allotted shares to a company and fair market value of shares was done by a Merchant banker only on basis of Discounted Cash Flow (DCF) method, only depending on data supplied by assessee and no evidence was produced for verifying correctness of data supplied by assessee, Assessing Officer was justified in rejecting DCF method and adopting Net Asset Value method- ***Agro Portfolio (P.) Ltd [2018] 94 taxmann.com 112 (Delhi - Trib.)***

- In the case of ***TUV Rheinland NIFE Academy Pvt Ltd [TS-92-ITAT-2019(Bang)].*** also upheld the view taken by the Delhi bench of the Tribunal in the case of ***Agro Portfolio.***

Angel Tax
Case Law

- *If the valuation report is based on the irrelevant material then the AO is duty bound to correct it with the relevant materials. The Tribunal has further gone ahead and has expressed that in its view the AO not only has a right but is duty bound to examine the valuation report. Thus, this decision has given very wide powers to the AO to examine the valuation report submitted by the taxpayer.-* ***Microfirm Capital (P.) Ltd. [2018] 89 taxmann.com 23 (Kolkata - Trib.)***

Section 54EE

- Sec. 54EE- Investment into units of **"Fund of Funds"** under Start up India Action Plan

- Capital Gains from **transfer of a Long term capital asset**
- Investment of whole or any part of capital gains in the Long Term specified asset (LTSA), within 6 months from such transfer- Maximum Rs. 50Lakh

Quantum of exemption:

- Cost of Asset > Capital Gains – Entire gains exempt
- Cost of Asset < Capital Gains – (Entire capital gains)*(Amount Invested/Entire gains)

LTSA transferred before 3 years- Capital gains exempt earlier chargeable to tax in year of transfer of long term specified asset

LTSA- Units of notified fund issued before April1, 2019.

Way forward

- It is desirable that Government should also exempt the transactions of pre Notification period or give instructions to the field officers not to contest further in the litigation, in case Startup companies get relief at the appellate level.
- Provisions of Sec.80IAC must be modified in line with Notification
- CBDT should also instruct field officers not to invoke provisions of sec.68 in the said context of receiving share capital investment with premium

Thank You