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TAX RELIEF FOR START-UPS

The Department of Industrial Policy and Promotion ("**DIPP**") of the Ministry of Commerce and Industry of the Government of India ("**GOI**"), vide Notification No. G.S.R. 364 (E) dated April 11, 2018 ("**Notification**"), has laid down the eligibility guidelines and the procedure for availing direct tax benefits including exemption from "angel tax" for Start-ups.

The new notification comes in light of (i) DIPP cancelling the certifications of certain companies which were misusing the Start-up India Initiative (for example, entities which were merely subsidiaries of foreign companies, but obtaining registration in India as Start-Ups); and (ii) Start-ups receiving tax notices seeking to tax the premium received by the Start-up on the shares issued above the fair market value, also known as the "angel tax".

KEY HIGHLIGHTS OF THE NOTIFICATION

DIPP had earlier issued (i) Notification G.S.R No. 180(E) dated February 17, 2016 and (ii) Notification No. G.S.R 501 (E) dated May 23, 2017 ("**May Notification**") defining the eligibility criterion for Start-ups and procedure for availing tax benefits. The recent Notification will now supersede the May Notification.

A. Definition of Start-up

The definition of Start-up as set out in the recent Notification remains unchanged and in-line with the May notification, which provides that an entity will be considered as a Start-up:

i. for a period of 7 years (or 10 years in the Biotechnology sector) from the date of incorporation as a private limited company, partnership firm or a limited liability partnership;

ii. if its turnover for any financial year since incorporation has not exceeded INR 25 crores; and

iii. it 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.

Analysis: *As per the February 2016 notification, an entity could be considered as a Start-up only if it was providing services driven by technology or intellectual property. Now as per the recent Notification which is in-line with the May Notification even non-technology driven companies having a scalable business model with a high potential of* *employment generation or wealth creation will be considered as a Start-up. However, there is ambiguity in relation to how "high employment generation" or "wealth creation" will be determined and it would be helpful if the criterion/ingredients for determining the same are set out by the GOI to avoid interpretational challenges.*

B. Process of Recognition

The process of recognition of an entity as a Start-up also remains unchanged and is in-line with the May Notification, which requires

i. Online application made over the mobile app/portal set up by the DIPP;

ii. Accompanied with (a) copy of Certificate of Incorporation/Registration, and (b) a write-up about nature of business;

Analysis*: The process of recognition as a Start-up is the same as the May Notification which had done away with the onerous requirement of obtaining recommendations/letter of support from Government funds, incubators and industry associations which was a major deterrent for companies against obtaining Start-up registration*

C. Certification for the purposes of Income-Tax Relief

The notification provides that a Start-up incorporated between the period of April 1st, 2016 and April 1st, 2021 may make an application in the prescribed Form-I to the Inter-Ministerial Board of Certification ("**IMB**"), which will, after reviewing the application grant a deduction of 100% on profits for three out of seven years on the total income of the assessee Start-Up (under Section 80-IAC of the Income Tax Act 1961).

Analysis: *Although, the recent Notification in line with the May Notification provides tax exemptions to Start-ups by way of profit-linked tax holiday for three years, it is important to note that (i) the exemption is subject to IMB approval (which would be based on the innovative level of the Start-up); and (ii) the exemption is not all-encompassing and for Start-Ups incorporated before April 2016, no relief has been made available. It would have been beneficial if the exemption could have been extended to Start-ups incorporated prior to April 2016 as well.*

D. Further Tax Exemption on Excess Consideration against Shares

Section 56 (2) (vii) (b) of the Income Tax Act, 1961 (the "**Act**") introduced with effect from April 1, 2013 by the Finance Act, 2012 provides that if a closely held Indian private company issues shares to a resident in excess of the fair market value ("**FMV**") of the shares, the said excess amount will be taxed as income in the hands of the company. The method of determination of FMV includes valuation as per the Discounted Free Cash Flow ("**DCF**") method determined by a merchant banker or an accountant which encompasses determination of FMV based on projections of future profits of the business of the Start-up.

Given that a number of Start-ups received tax notices from assessing officers who questioned the valuation of Start-ups as per DCF method and brought the difference to tax as income under Section 56 (2) (vii) (b) of the Act, the Central Board for Direct Taxes ("**CBDT**") issued Notification no. F. No. 173/14/2018 dated February 6, 2018 directing the assessing officers to refrain from taking coercive measures against "Start-ups" to recover taxes under section 56(2)(vii) (b) of the Act.

The recent Notification prescribes conditions for seeking approval for exemption from "angel tax" for both Start-up companies and investors. To seek the exemption, the below conditions need to be fulfilled-

i. Post-issue, the aggregate amount of paid-up share capital and share premium should not exceed INR 10 crores;

ii. Investor has (a) average returned income of INR 25 lakhs for the last 3 financial years, or (b) a net worth of 2 crores or more as on March-end of preceding financial year;

iii. The Start-up has obtained a certificate from a merchant banker stating that the FMV of the shares is in accordance with the Income Tax Rules, 1962.

The application has to be made in the prescribed Form-2 to the IMP, which will, after reviewing the application, grant an approval to claim said exemption.

Analysis: *The "angel tax" relief is a move which we expect would be appreciated within the Start-Up community given that a lot of Start-Ups usually issue shares at a premium. While government initiatives towards the "angel tax" exemption are genuine, there do exist problems that needed to be resolved –*

A. ***Costly affair:*** *Seeking a merchant banker certification for the FMV of shares is a big hurdle and entails paperwork and expenses. Typically, chartered accountants do the valuation.*

B. ***Red-tape dependence:*** *As mentioned above, the requirement of IMB approval/certification based on the "innovativeness" of the Start-up is only going to create more red-tape hassle. It may be noted that out of approx. 8,765 Start-ups recognized by the DIPP only 88 have received IMB certification and hence, the possibility of Start-ups being rejected by the IMB and not being able to avail the "angel tax" benefits cannot be ruled out.*

C. ***May Discourage Investors:*** *Further, there may be situations where a Start-up despite being innovative does not get angel investments due to non-procurance of IMB certification, as investors would prefer entities which can avail such "angel tax" exemption. Hence, this may potentially discourage potential investors in a promising Start-up.*

D. ***Other Existing Challenges:*** *Another unconnected example of a tax concern could be the Income Tax Department's move to tax entities which have fluctuating DCF projections. For example, a Start-up which has a high valuation as per DCF on current date (due to funding) may have a lower DCF valuation 12 months down the line if things do not work out – which is largely the case with Start-ups. Income Tax authorities seek to tax such entities. In our view, DCF valuations may not be the most accurate criteria because they take projected valuation 5 years from date.*

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