STARTUP – DIRECT TAX AND REGULATORY ASPECTS

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Evolution of Startup Regulations

DPIIT / DIPP Notifications

Tax amendments

17 Feb 2016 – First Notification in relation to Startup was issued by DPIIT. Focus was on technological & intellectual property

Budget 2016 – Budget 2016 introduced Tax holidays for Startup u/s 80 IAC, 54GB, effective from 2016-17

14 June 2016 – CBDT by notification granted an exemption to Startup company from the applicability of section 56(2)(viib)

23 May 2017 – Notification issued to expand definition of start and extend the tenure of eligible startup from 5 yrs to 7 yrs

Budget 2018 – Budget 2018 amended Section 80 IAC to increase the tenure, widen the definition and Section 79 to liberalize the c/f loss condition for the Startup

11 Apr 2018 – Notification issued to provide guidelines to Startup to claim exemption u/s 56(2)(viib)

16 Jan 2019 – Notification issued to change the investors relating conditions for claiming an exemption u/s Sec 56.

Budget 2019 – Budget amended section 79 to relax some conditions for c/f of losses in the case of Startup

19 Feb 2019 – Notification issued to amend the startup guidelines-change in turnover criteria and conditions for claiming exemption u/s 56(2)(viib)

Aug/ Sep 2019 – Multiple circulars were issued by CBDT to clarify the issues related to section 56(2)(viib), assessment of Startup, set up of dedicated cell for addressing the specific problems of Startup

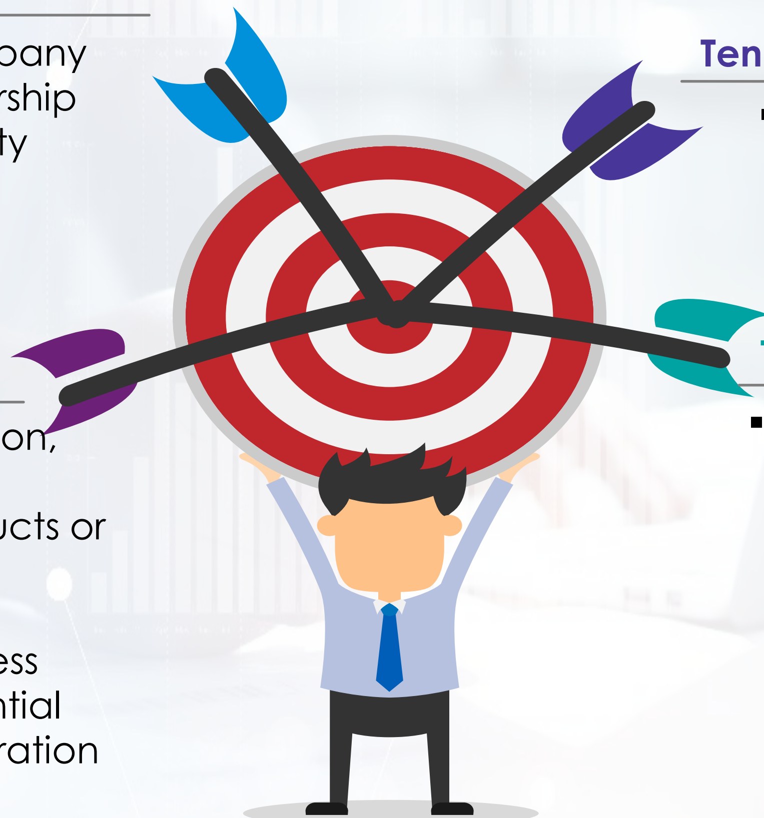
So for more than 25,000 Startup are recognized by DPIIT

Startup Definition – DPIIT notification

Eligible Startup

Entity Type

- Private Limited Company or Registered Partnership Firm or Limited Liability Partnership



Tenure

- Upto 10 years from the date of incorporation / registration

Nature of Business

- Work towards Innovation, Development, improvement of products or services or process

- If it is a scalable business model with high potential for employment generation or wealth creation

Turnover

- Turnover not to exceed INR 100 Cr in any financial year since incorporation / registration

Nature of business is subjective – in absence of specific guidelines
Entity should not be formed "by splitting up or reconstruction of an existing business"

Startup – Registration with DPIIT

Registration Process

Application for recognition as startup	▪ Online application through mobile application or portal set-up by DIPP
Documentation	▪ Following documents to be uploaded along with the application – Copy of Certificate of Incorporation – Write-up about the nature of business
Evaluation of the application	▪ DPIIT to evaluate the application and call for additional documents or information ▪ DPIIT to make enquiries if required
Certificate	▪ On completion of evaluation-DPIIT to recognize the entity as startup or reject the application

No time line prescribed for approval of the application

Tax Incentives and Related Aspects

Incentives for Startup under Income-tax

Tax Holiday – U/s 80IAC

Capital Gains – U/s- 54GB

Carry Forward of Losses – U/s 79

Exemption U/s 56(2)(viib)- Angel Tax

Tax Holiday – Section 80-IAC

Type of Startup

- Private Limited Company
- Limited Liability Partnership

Registered partnership are not eligible for benefit under Section 80 IAC

Eligible Startup

- Incorporated on or after April 1, 2016 but before April 1, 2021
- **Total turnover does not exceed INR 25 Crs**
- Hold certificate of eligible business from Inter Ministerial Board of Certification ('IMBC')
- It is not formed by transfer of used plant or machinery (subject to certain exception)
- Not formed by splitting up or reconstruction of an existing business

Eligible business

- Work towards Innovation, Development, improvement of products or services or
- Scalable business model with high potential for employment generation or wealth creation

Incentive

- Claim deduction of 100% of profits derived from Eligible business for any 3 consecutive years out of 7 years beginning from the year in which Eligible Startup is Incorporated.

Splitting up or reconstruction of an existing business ?

Splitting-up or Reconstruction of business

- Not a defined term under the IT Act

- Judicial precedents has laid down following principles to evaluate "Splitting up" or "Reconstruction" of business
  - New business should be separate and distinct from the existing business
  - No interdependence of unit/entity
  - Books of accounts should be separate
  - Employment of requisite manpower therein
  - Earning of profits clearly attributable to the new business

To be evaluated on case to case basis

Case Study –Split up or Reconstruction of business

Case I

A ltd

B Ltd (Existing) | C Ltd (New)

- No assets transferred
- Same line of business
- Business of B Ltd was not impacted

Case II

A ltd

B Ltd (Existing) | C Ltd (New)

- No assets transferred
- Different line of business
- Business of B Ltd is not impacted

Case III

A ltd

B Ltd (Existing) | C Ltd (New)

- Transfer of Land and Building but no Plant and Machinery
- Different line of business
- Business of B Ltd was not impacted

Case IV

A ltd

B Ltd (Existing) | C Ltd (New)

- Assets of old unit were used but not transferred to new entity
- Different line of business
- Business of B ltd was impacted

Startup – certificate from IMBC

Recognition Process

Application for recognition as Startup	▪ Application in Form 1 to be filed to IMBC
Documentation	▪ Following documents to be uploaded along with the application – Copy of Certificate of Incorporation/ MOA/ LLP deed – Write-up on existing and proposed business
Evaluation of the application	▪ IMBC to evaluate the application and call for additional documents or information ▪ IMBC to make enquiries if required
Certificate	▪ On completion of evaluation – IMBC to grant the certificate or reject the application

No time line prescribed for approval of the application

Other Aspects of Section 80-IAC

Reality Check on 80-IAC benefit

- May not be relevant for startup which takes 4 to 5 years to be profitable. They will first set off their brought forward losses. Only if there is any excess profit after set off, it will claim deduction under Section 80-IAC

MAT Applicability

- MAT is applicable on entity claiming 80-IAC benefit
- Exemption could have been provided to Startup for non-applicability of MAT provisions to extent of deduction claimed under Section 80-IAC

Approval from Inter-Ministrial Board of Certificate

- No specific criteria's are prescribed regarding qualification of Startup
- In one of IMBC meeting it was discussed that
  - **The applications should not be rejected merely on the basis of similar products / services as it could mean higher demand and competition.**
  - **Efforts should be made to encourage startup in rural areas.**
  - **May ask startup to record a video of a defined duration explaining specified points about the startup or have video conferencing with startup**

Capital Gains

Section 54 GB

Long Term Capital gains investment in Startup

- 54GB allows the exemption from tax on long-term capital gains arising on transfer of a residential property (house or plot of land) by Individual or HUF if-
  - Net consideration are invested in the subscription of equity shares of a eligible startup before the due date of furnishing the return of income under section 139(1).
  - The company has within 1 year from the date of subscription in equity shares utilized the amount invested for the purchase of new asset.
  - such shares are not sold or transferred by the investors within 5 years from the date of its acquisition
  - The Startup shall not transfer the new asset purchased within 5 years (3 years for technology driven Startup) from the date of its acquisition and

- **This exemption may boost the investment in eligible Startup and will promote their growth and expansion.**

Carry forward of Losses U/s 79

Carry Forward of Losses U/s 79

- Under Section 79, where there is a change in beneficial ownership of 51% of voting power of a closely held company from the end of the year in which a loss was incurred to the end of the year in which the set off of the loss is claimed, the benefit of set-off and carry forward of loss is not available.

- The objective behind this provision is to prevent transfer of loss making companies, where the benefit of the set-off losses can be availed by the acquirers.

- In Startup transfer of voting is quite common on dilution by founder at each round of funding, resulting to no availability of carryforward losses.

- Hence, concession has been provided for a startup which **is eligible for deduction u/s 80-IAC** can continue to obtain the benefit of carry forward **and set off of losses of the first seven years from the date of incorporation**, provided –

  - *"**all the shareholders holding shares of the company in the year in which the loss was incurred continue to be shareholders of the company as at the end of the previous year in which the set-off of the loss is being claimed.**"*

Even if one shareholder of the Startup transfer its nominal shareholding before set-off of the loss, the specific benefit available to such Startup will be lost

Angel Tax-Section 56(2)(VIIb)

01 SECTION 56(2)(VIIB)

Section 56(2)(viib) of the Act provides that in case a company in which the public are not substantially interested, issues shares at a premium, the excess of share issue price over the fair market value of such shares, computed in accordance with the prescribed methodology, shall be subject to income tax

02 ANGEL TAX ISSUE

During assessment proceedings, the income-tax authorities have been challenging the valuation of shares, mainly in relation to the funding received by Startup with respect to the premium receive in excess of fair market value of the shares.

03 EXEMPTION PROVIDED

The Government of India has been attempting to provide relief measures and exemptions to boost investment in Startup, and as a part of that the GOI issued a Notification 11 Apr, 2018 providing a procedure to grant exemption from section 56(2)(viib) of the Act to certain eligible Startup. On 16 Jan, 2019 it issued further notification to ease some of the conditions for claiming exemption

Angel Tax-Section 56(2)(VIIb)

Particulars	As per notification issued on 11 April, 2018 (as modified by notification dated 16 January, 2019)	As per notification issued on 19 February, 2019
Duration of recognition as Startup	10 years for Startup in the biotechnology sector and 7 years for others	10 for all entities
Turnover limit	Turnover for any Financial Year since incorporation/ registration of the entity not exceeding INR 25 Cr	Turnover for any FY since incorporation/ registration of the entity not exceeding INR 100 Cr
Threshold limit of share capital and share premium to become eligible for exemption	Aggregate paid-up share capital and share premium of the Startup after the proposed issue of shares does not exceed INR 10 Crs	Aggregate paid-up share capital and share premium of the Startup after the proposed issue of shares does not exceed INR 25 Cr. Further the shares issued to following person shall not be included for computing such limit – • A non-resident • A venture capital company or a venture capital fund registered as Category I AIFs; or • A specified company
Prescribed conditions for investors in Startup	The investor/ proposed investor shall have: • Returned income of INR 50 lakhs or more for the FY preceding the year of investment/ proposed investment; and • Net worth exceeding INR 20 lakhs on the last date of the FY preceding the year of investment/ proposed investment	These conditions for investors no longer apply

Angel Tax-Section 56(2)(viib)

Particulars	As per notification issued on 11 April, 2018 (as modified by notification dated 16 January, 2019)	As per notification issued on 19 February, 2019
Restriction on investments by Startup	No conditions prescribed.	The Startup should not have invested in any of the following assets: • Building or land being a residential house, uless it is used for the purposes of renting or held by it as stock-in-trade, in the ordinary course of business; • Loans and advances, other than extended in the ordinary course of business by the Startup where the lending of money is a substantial part of its business; • Capital contribution made to any other entity; • Shares and securities; • A motor vehicle, aircraft or any other mode of transport actual cost of which exceeds INR 1 mn • Jewelry or any other asset, whether in the nature of capital asset or otherwise, of the nature of drawings, painting, art work, sculptures or bullions.
Requirement of report from merchant banker	As per the 11 April, 2018 notification , a Startup was exempted from section 56(2)(viib) of the Act if, the Startup has obtained a report from a merchant banker specifying the fair market value of shares in accordance with Rule 11UA of the Rules.	No requirement to obtain a valuation report as per the new notification
Approval Process	Exemption under Section 56(2)(viib) was subject to the approval of CBDT	No approval of CBDT is required. Only a declaration needs to filed by a the Startup registered with DPIIT

Key Highlights of DPIIT

1

Retrospective effect

The notification shall apply irrespective of the dates on which shares are issued by the Startup from the date of its incorporation

2

No Valuation report required

The earlier condition to submit the valuation report as per Rule 11UA of the Income-tax Rules, 1962 (Rules)

3

Retrospective Withdrawal of exemption on breach of conditions

In case of breach of any condition, the exemption provided under section 56(2)(viib) of the Act shall be revoked with retrospective effect.

4

Procedure of application

To avail this exemption, only signed declaration in Form-2 to needs to be filed to the DPIIT. On receipt of such declaration, the DPIIT shall forward it to the CBDT. No approval from the CBDT required

Regulatory

Relaxations by RBI

Foreign Investments

FDI

- Equity
- CCDs
- CCPS

Subject to pricing guidelines

- **Convertible Notes**

FPI

- Listed Shares / NCDs
- IPO / Private Placement
- Secondary Market
- CPs, SR (ARCs), MF Units, G-Sec, T-Bills
- QIB status

FVCI

- Equity Shares / CCPS / CCDs
- Primary issue + Secondary purchase
- No pricing
- No lock-in
- Takeover exemption
- **Sector restriction – Investment in Startup permitted without any sector restriction**

Others

- **ECB**
- REIT/ InvIT
- Rupee denominated bond (Masala bonds)
- P-Notes/ GDR / ADR / FCCB / FCEB

Different investment routes necessary to ensure flexibility to make different investments

Relaxations by RBI

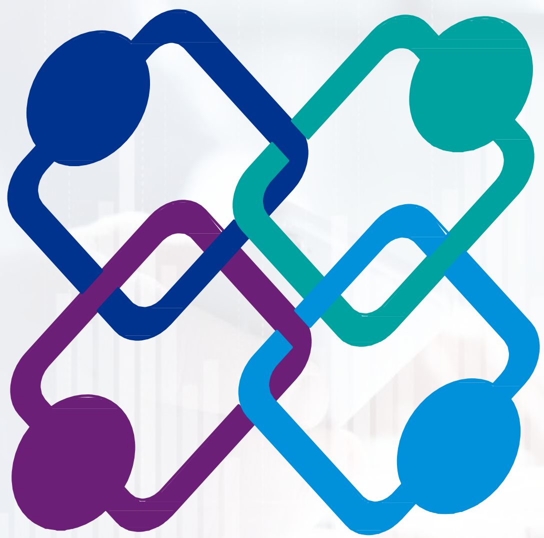
2. Foreign Direct Investment in Startup

Issue of Convertible Notes ('CN')

- Instrument evidencing initially as debt
- Repayable at the option of the holder or convertible into equity shares within 5 years as per the terms agreed for the intrument

Purchase / Sale by NRI or OCI

- Investment to be on non-repatriation basis



Regulation for issue of CN

- Min of INR 25 Lakhs in a single tranche
- Government approval required in case of sectors which requires approval of Government
- Transfer from NR to NR or NR to R possible
- Conversion of note into equity must be in accordance with the pricing guidelines applicable to the capital instrument

Reporting with RBI

- Reporting by Startup in Form CN within 30 days of issue
- In case of transfer, resident to report details of transfer within 30 days of transfer

Relaxations by RBI – ECB Regulations

For Startup

Eligible Lenders	The lender / investor should be resident of FATF compliant country
Eligible Borrowers	Entity recognized as a Startup by the Central Government as on date of raising ECB
Maturity Period	Minimum average maturity period (MAMP) of 3 years
Amount of Borrowing	Maximum of USD 3 million or equivalent per financial year
All-in-cost	Shall mutually agreed between the borrowers and lenders

Relaxations by RBI – ECB Regulations

For Startup

End-use

Any expenditure in connection with the business of the borrower

Conversion into equity

Conversion into equity is freely permitted, subject to Regulations applicable for foreign investment in Startup

Key Factors for setting Startup outside India

01 Whether Startup has the potential to grow business globally?

02 Whether Startup has substantial customer base outside India?

03 Whether Startup has people to operate business outside India?

04 Whether Founder members have any plans moving outside India?

05 Whether Startup need any customer facing functions to be present outside India?

06 Whether Startup plan to raise investment from foreign investors?

FAQs on Overseas setup of Startup

If founder is an Indian resident ,can he operate with only a Overseas company and not have any Indian entity at all?

Key Parameters to be taken care of –

1. FEMA restrictions
2. Potential risk exposure of POEM on foreign company – Global income can be taxed in India
3. Cost – benefit analysis
4. Substantial manpower at overseas base to operate business

Should overseas entity be a subsidiary of India or Should the India entity be a subsidiary of overseas entity?

Key Parameters to be taken care of –

1. Potential risk exposure of POEM/Permanent Establishment
2. Are your founder members based out of India
3. Whether you need major operations to be performed in India or only the backend operations
4. FEMA Regulations
5. Applicability of transfer pricing provisions

Wishlist for Startup

- Regime with less tax compliances
- Exemption from TDS compliances
- Non applicability of TDS on payment made to Startup
- Limited assessment scrutiny for Startup
- Waiver of applicability of MAT on deduction claimed under section 80-IAC

This would allow Startup to focus on their business and improve productivity instead having a part of their energy diverted towards compliances

Thank You