

TAX FLASH NEWS

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Ministry of Commerce and Industry clears proposal to encourage investments into startups (Angel Tax Notification)

Background

In order to catalyse entrepreneurship by enabling angel investments to innovators across all sections of society and all sectors of economy, a Gazette notification in partial modification of Gazette Notification number G.S.R 364(E), dated 11 April 2018 was issued on 16 February 2019. However, concerns were expressed regarding taxation of angel investments and certain issues needed clarity to ensure availability of capital to startups.

The Department for Promotion of Industry and Internal Trade (DPIIT) recognises certain entities as 'startup' based on the satisfaction of qualifying conditions. Such recognition as a 'startup' is relevant from the perspective of Income-tax Act, 1961 (the Act) in the context of profit-linked tax holiday [Section 80-IAC] and exemption from angel tax provisions [Section 56(2)(viib)].

The Notification

Recently, the (DPIIT) vide Notification No. G.S.R. 127(E) dated 19 February 2019 prescribed amendments in the definition of 'startup' and substantial relaxation in the conditions and procedure for availing an exemption from angel tax.

With this notification, the definition of startup has been enhanced. Now an entity shall be considered as a startup up to a period of ten years from the date of incorporation/registration in place of the earlier duration of seven years. Similarly, an entity will continue to be recognised as a startup if turnover of the entity for any of the financial years since incorporation/ registration has not exceeded INR1000 m in place of INR250 m earlier.

This will have a favourable impact on exemption from 'angel tax' but may not have similar impact on profit-linked tax holiday provision which continues to have condition of turnover cap of INR250 m and tax holiday period of any three consecutive years within seven years from date of incorporation or registration.

The cap on aggregate share capital and share premium consequent to past or proposed issue of shares by 'startup' company has been raised from INR100m to INR 250 m.

The Notification provides that the enhanced cap of INR250m shall not include shares issued to a non-resident, Venture Capital Company (VCC) or a Venture Capital Fund (VCF). Furthermore, investment by a listed company whose shares are frequently traded having a net worth of INR1000m as on the last day of preceding financial year or turnover of INR 2500m for the preceding FY shall be exempt from application of angel tax as also excluded from cap of INR250m.

It may be noted that the angel tax statutorily exempts investments by VCCs/VCFs, but the exclusion provided in the new Notification benefits startup companies by not counting such exempt investment for reckoning the cap of INR250m relevant for other investors. The earlier notifications did not contain a similar exclusion.

While the Notification refers only to VCC/VCF [being statutorily defined in the ITL as a sub-category of Category I Alternative Investment Fund (AIF)], the Press Release by the Ministry of Commerce and Industry refers to Category-I AIF, which is a larger class covering other sub-categories like small and medium enterprise fund, social venture fund, infrastructure fund, etc. The ambiguity on the scope of exclusion will require further clarification.

The Notification substitutes the approval based process for availing exemption by a self-declaration based process. It requires the startup company to file a declaration with DPIIT for availing exemption which shall be transmitted by DPIIT to CBDT.

The Notification dispenses with net worth and income criteria for resident investors as also justification for valuation of shares. Thus, investment by any resident investor is permitted and a startup company will not be questioned on valuation of shares as long as other conditions are satisfied.

To ensure that the exemption is restricted to bona fide cases having regard to anti-abuse intent of 'angel tax' provisions, the Notification prescribes end-use restrictions that the startup company should not invest in any of the following assets for a period of up to seven years from the end of the latest FY in which shares were issued at premiums:

- Building or land appurtenant thereto, being a residential house, other than that used by the startup for the purposes of renting or held by it as stock-in-trade, in the ordinary course of business.
- Land or building, or both, not being a residential house, other than that occupied by the startup for its business or used by it for purposes of renting or held by it as stock-in trade, in the ordinary course of business.
- Loans and advances, other than loans or advances extended in the ordinary course of business by the startup where the lending of money is substantial part of its business.
- Capital contribution made to any other entity.
- Shares and securities.
- A motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds ten lakh rupees, other than that held by the startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business.
- Jewellery other than that held by the startup as stock-in-trade in the ordinary course of business.

- Any other asset, whether in the nature of capital asset or otherwise, of the nature specified in sub-clauses (iv) to (ix) of clause (d) of Explanation to clause (vii) of sub-section (2) of section 56 of the Act¹.

It may be noted that the end-use restrictions are not specific to the share issue proceeds which are sought to be exempted under the Notification, but apply to investment from any funds (including borrowed funds) available with the startup.

Breach of the end-use restriction shall result in retrospective revocation of the exemption from angel tax provisions. The start-up company will then need to justify the valuation of the shares issued to the resident investor.

The Notification comes into effect from 19 February 2019 being the date of its Notification in the Official Gazette. It supersedes the 2018 Notification as amended by January 2019 Notification.

Our comments

The relaxations introduced by this Notification are a welcome move as they seek to expand the definition of startups to cover a large number of entities and for a longer duration. This enables the entities to avail tax and non-tax benefits granted to startups.

By providing a self-declaration process without the need to justify share valuation or prove credentials of investors but with a cap of INR250m and end-use restrictions, this Notification attempts to provide a balance between 'ease of doing business' for startups and addressing the anti-abuse concerns of the government.

However, the ambiguity on exclusion for investments by sub-categories of Category I AIF (other than VCC/VCF) requires to be resolved by DPIIT.

It is important to note that in case of certain startups, the tax authorities have invoked broader provisions to treat share investments by non-resident investors as unexplained cash credits. This Notification does not seek to address the controversy relating to investments by non-resident investors.

¹ Archaeological collections, drawings, paintings, sculptures, any work of art, bullion (whether or not capital asset)

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