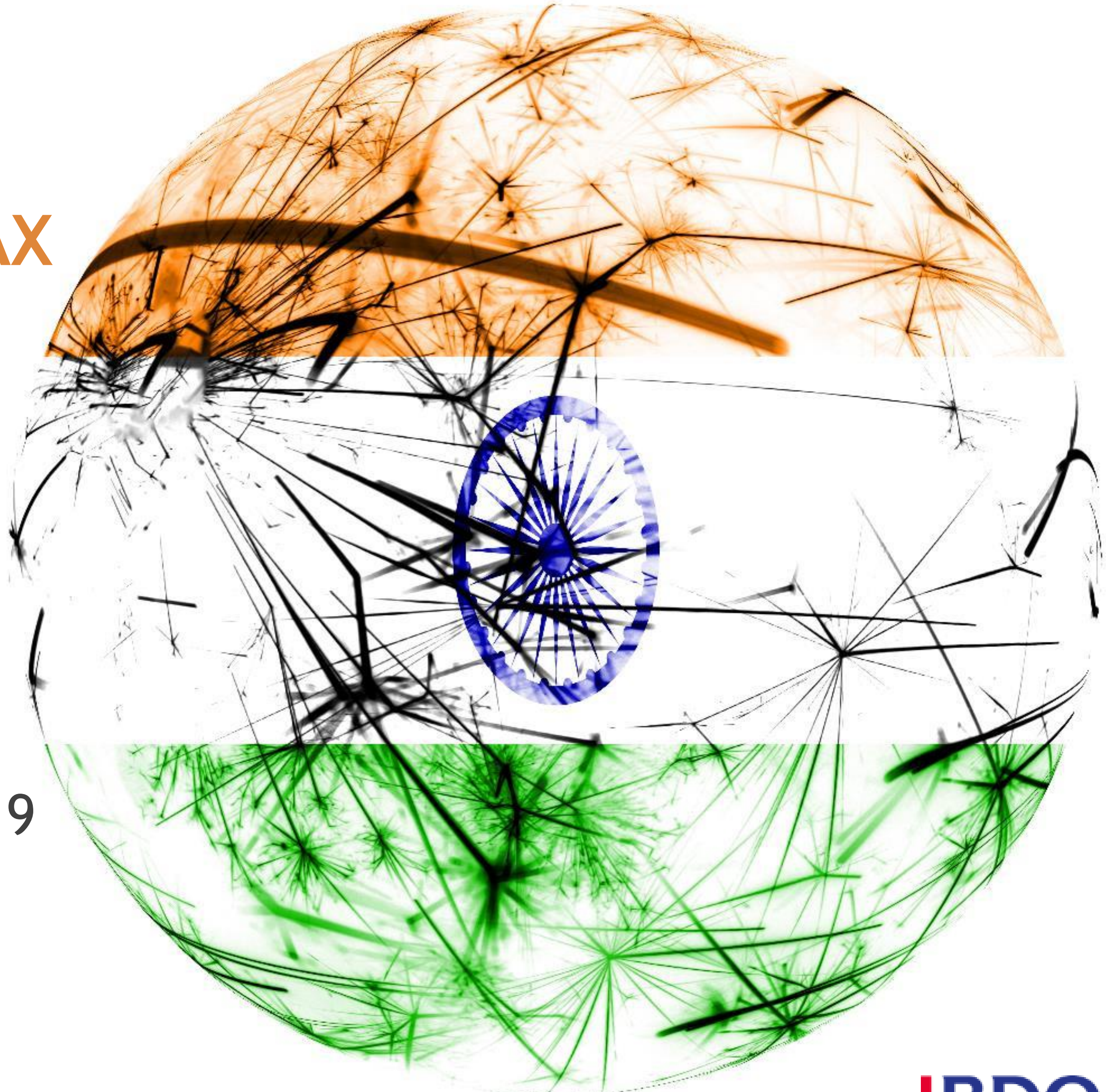
TECHNICAL TAX ASPECTS & REGULATORY POLICY ASPECTS FOR START-UPS



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AREAS OF EXPERTISE

- Indian Income Tax
- International Tax
- Transfer Pricing

INDUSTRY EXPERTISE

- IT / ITeS
- Engineering Services
- Telecom
- Consumer Markets

EDUCATION & PROFESSIONAL QUALIFICATIONS

- Chartered Accountant - ICAI
- Master of Management Studies (Finance)
- Bachelor of Commerce

EXPERTISE SUMMARY

- Pankil is a Partner with the Tax & Regulatory practice.
- He operates out of Bangalore office and has 16 years of professional experience in handling Domestic Tax, International Tax and Transfer Pricing engagements.
- Prior to joining BDO, he has worked with larger accounting firms and has a diverse experience in servicing multinationals, Indian groups, start-ups and SMEs.
- Pankil has led several engagements in India and Internationally across diverse industry verticals like IT/ITeS, Engineering Services, Manufacturing, Consumer Markets, Telecom, etc .
- Pankil has contributed to several Indian business newspapers and professional magazines. He has also been a regular speaker at several local and national forums.

SELECT KEY PROJECTS

- Conducted a High Value Tax efficient supply chain structuring for an Indian MNC client which had global tax implications
- Played the lead role in multiple projects involving relocation of HQ from India to overseas jurisdictions
- Played the lead role in Global Transfer Pricing documentation for major MNC groups involving Indian as well as foreign companies
- Assisted a global telecom major in conceptualising, setting up and implementing its global Residual Profit Split Transfer Pricing model
- Argued a complex and high stakes Tax and Transfer Pricing matter before the Appellate Tribunal
- Assisted a top Fortune 500 Company in a high stakes survey proceeding and litigation relating to ‘permanent establishment’ and ‘profit attribution’

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WHAT IS START-UPS

WHAT IS START-UPS – DPI&IT DEFINITION

As per DPI&IT, Notification dated 19 Feb 2019, an entity shall be considered as a Start-up if it satisfies following conditions:

- ✓ Upto a period of ten years from incorporation if it is incorporated as a private limited company / partnership firm / limited liability partnership.
- ✓ Turnover **for any** of the financial years since incorporation / registration has not exceeded INR 100 crores.
- ✓ 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 'Start-up'.

WHAT IS START-UPS – 80-IAC DEFINITION

As per section 80-IAC of the Income-tax Act, **"eligible start-up"** means a company / LLP engaged in eligible business which fulfils the following conditions, namely:

- ✓ it is incorporated on or between 1st day of April, 2016 to 1st day of April, 2021;
- ✓ the total turnover of its business does not exceed INR 25 crores in the previous year relevant to the assessment year for which deduction is claimed; and
- ✓ it holds a certificate of eligible business from the Inter-Ministerial Board of Certification as notified in the Official Gazette by the Central Government;
- ✓ "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;

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TABLE – CONDITIONS FOR QUALIFYING AS START-UPS

Sl No.	Criterion	DPI&IT	80-IAC
1	No. of year of existence	Upto 10years from incorporation	01/04/2016 – 31/03/2021
2	Turnover	≤ INR.100 crores	≤ INR.25 crores in FY
3	Eligible business	1. Innovation/ development /improvement of product or process or services. 2. Business with a high potential of employment generation or wealth creation.	

EXEMPTION UNDER SECTION 80-IAC

- Union Budget 2018 extended the period of incorporation of startups to 1 April 2016 - 1 April 2021 for Section 80-IAC benefits
- 100% exemption granted (3 out of 7 years) to profits from specified start-ups
- Other key conditions:
  - Total turnover does not exceed INR 25 crores in any year
  - Obtains 80IAC Start-up certificate from DPIIT

DIFFERENT STAGES OF FUNDING

DIFFERENT STAGES OF FUNDING

Idea and Experimental phase

- **Bootstrapping**: Self-funding, also known as bootstrapping, is an effective way of start-up financing.
- **Crowdfunding**: It is like taking a loan, pre-order, contribution or investments from more than one person at the same time (e.g. friends, family, social media followers etc.)
- **Seed round**: This is where start-ups really onboard external capital providers such as angel investors, targeted funds, and even accelerators and incubators which have been separately under this section.

Building and growth stage

- **Series A**: At this stage, start-ups have conviction based on data and evidence on the ability, not necessarily in terms of revenue or profits. This could be based on traction generated or pipeline of opportunities identified.

  Series A funds would also be deployed for marketing and improving the brand credibility and hiring senior team members that gives more bandwidth to the founder.

DIFFERENT STAGES OF FUNDING

Building and growth stage

- **Series B**: With all engines on fire and the business taken-off, there is again a need of additional capital to achieve faster pace of growth to be ahead of competition. This represents a significant increase in the funding in start-up.

  Capital may be used for expanding teams, geographic expansion into new markets and generally scaling up of business including new products as well.

- **Series C and more**: A start-up at this stage indicate that it is really getting big. During Series C investment, the owners, as well as the investors, are cautious as it would release more business' equity from the owner / early investor in favour of incoming investor.

  Capital is used for consolidation of competition and for acquisition of talent to prepare for an exit.

INVESTMENT IN START-UPS - IMPLICATIONS

FUNDING IN START-UPS – IMPLICATIONS – EQUITY INVESTMENT

- India has allowed equity investment into almost all the sectors except some sectors.
- There are certain variants of equity investment which are as follows:
  - ✓ Equity shares/warrants
  - ✓ Compulsory Convertible Preference Shares (‘CCPS’)
  - ✓ Compulsory Convertible Debentures (‘CCD’)
- FDI is generally allowed upto 100% under automatic route including e-commerce subject to certain conditions (except few controlled sectors).
- Issue price for shares needs to be determined as per Internationally Accepted Pricing methods.
- CCPS and CCDs are saleable.

FUNDING IN START-UPS – IMPLICATIONS – EQUITY INVESTMENT

- As per Companies Act, the issue price for equity investments should be supported by valuation report required for preferential issue of shares. No such restrictions exist for a "rights issue" though.
- As per Income-tax Act, implications arise under Section 56(2)(viib), which is discussed in the ensuing slides

Implications for investors on Redemption / Buyback

- As per Foreign Exchange Regulations, no approvals required for redemption of Preference shares or Buyback of shares. Pricing guidelines will apply; pricing sale to a resident capped at the fair value.
- As per Companies Act, buy-back of equity shares is permitted where it is authorised by Articles of Association of the company and necessary threshold conditions are satisfied
- As per Income-tax, Capital gain tax on redemption. On buyback, there would not be any tax in the hands of the investor, as the company would have paid buy back tax @ 20%.

FUNDING IN START-UPS – IMPLICATIONS – DEBT INVESTMENT

- Typically, Start-ups find it difficult to obtain debt funding on account of the business risks. However, many a times, they could obtain debt in the form of the following instruments:
  - ✓ Optionally Convertible Debentures (‘OCDs’)
  - ✓ Optionally Convertible Preference Shares (‘OCPS’)
  - ✓ Non-Convertible Debentures (‘NCDs’)
- Investment by way of OCDs / OCPS / NCDs from foreign players would qualify as Debt or External Commercial Borrowings (ECBs) in India until a specific regulatory framework is notified for such hybrid instruments.
- ECB can be raised only after obtaining the Loan Registration Number from RBI.
- Conversion of ECB into equity is permitted subject to conditions.
- As per Companies Act, preference shares can have a maximum redemption period of 20 years. Additionally, approval of shareholders may be required if borrowing exceeds specified limits.

FUNDING IN START-UPS – IMPLICATIONS – DEBT INVESTMENT

- As per Foreign Exchange Regulations, there is no specific restriction on redemption / repayment of NCD or loan on maturity.
- Prepayment of NCD / loan may be allowed by Authorised Dealers (banks) without prior approval of RBI subject to compliance with the stipulated minimum average maturity period.
- No specific implications as per Companies Act and Income-tax on repayment of Principal amount.
- For foreign investors, the debt route is the most tax optimal route if tax is the main consideration (typically tax is not the main consideration, it is safety, value appreciation, etc.).
- Venture Debt is a new trend for Start-ups – rights to purchase equity for default – upfront equity dilution minimized.
- Bridge Financing at term sheet stage is also popular.

FUNDING IN START-UPS – CONVERTIBLE NOTES

- The government has allowed eligible start-ups to raise capital by way of issuance of Convertible notes.
- It is an instrument issued by a start-up company evidencing receipt of money initially as debt.
- Such convertible notes are either repayable at the option of the holder or convertible into such number of equity shares of such start-up company within a period not exceeding five years from the date of issue of the convertible note as per terms and conditions agreed.
- Given the challenges involved in the valuation of start-ups at early stage, this convertible note structure affords the necessary flexibility in structuring deals involving a dilution linked to milestones agreed.
- Seed investor and founders also have an added advantage of valuation cap and discount at the time of conversion during Series A round.

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TAX ISSUES FOR START-UPS

CONTENTIOUS “ANGEL TAX” ISSUE - 56(2)(viib)

- It is a termed coined by business community, and refers to Section 56(2)(viib) of the IT Act which was introduced in the Income-tax Act with effect from 1 April 2012, seeking to tax any excess premium received by a closely held company upon the issue of shares.
- Such excess premium is deemed to be the income of the company issuing shares and shall be taxed in its hands as “Income from Other Sources”.
- The intent of the legislature in enacting this section was to discourage anti-black money / money laundering measure to pass on funds to existing shareholders without the back-up value.

CONTENTIOUS "ANGEL TAX" ISSUE - 56(2)(viib)

- The excess premium for the purposes of computing the deemed income and tax liability under this clause is arrived at a differential between the FMV of the Start-up company's shares and the amount invested.
- Illustration:

Particulars	Amount (INR)
Amount invested per share (A)	200
FMV per share as per applicable rules (B)	150
Income from Other Sources (A-B)	50

- The FMV for the purposes of this Section is to be determined as per the valuation Rules prescribed. On a broad level basis following methods are prescribed :
  - Net Asset Value Method [Rule 11UA(2)(a)]
  - Discounted Cash Flow Method [Rule 11UA(2)(b)]; and
  - Any other method which the company can substantiate to the satisfaction of the tax officer. [Section 56(2)(viib)]

EXEMPTION UNDER ANGEL TAX

- Blanket exemption VC Company / VC Fund – now extended to CAT II – AIF (except NBFCs and listed companies)
- Further exemption provided for Start-ups where:
  - Post issue share capital plus premium does not exceed INR 25 crores – investments by VCC/ VCFs, listed Cos (with specified thresholds) and NRs not counted
- Restrictions on investments in any securities and other specified assets
- **Foreign investment not covered**
- **Investment in listed company or subsidiary thereof not covered**

CONTENTIOUS “ANGEL TAX” ISSUE – 56(2)(viib)

- A technical issue to be considered in this regard is whether or not a tax officer would be permitted to challenge the valuation conducted by a registered valuer in accordance with the Rules. Key judicial precedents could be considered as a guide in examining the above question.
- In the case of **Innoviti Payment Solutions Private Limited (Bangalore Tribunal) [TS-4-ITAT-2019 (Bang)]**, the tax payer was challenged on the projections used for DCF valuation. The Tribunal sought guidance from the CA institute’s Technical Guide on share valuation. The guidance note laid emphasis on the assumptions behind the projections used for conducting DCF valuation. The Tribunal agreed to the fact that adoption of the DCF method cannot be challenged. However, the Tribunal opined that the tax officer can examine the appropriateness and the underlying assumptions in arriving at the projections for DCF valuation. In case the tax payer is not able to establish the fact that such projections were made applying scientific methodology for estimation, the tax officer can challenge such projections and consequentially the valuation itself.
- There is also a contradictory view by the **Bangalore Tribunal** in the case of **TUV Rheinland NIFE Academy Pvt Ltd. [ITA No.3160/Bang/2018].** The Tribunal held that even the valuation methodology can be challenged if its veracity is not appropriately established.

CONTENTIOUS “ANGEL TAX” ISSUE – 56(2)(viib)

- Based on the above, it appears that while the tax officer ought not to challenge the valuation method adopted, the validity of projections in a DCF scenario may be verified. The tax payer may be required to provide a best estimate and scientific basis for the projections, considering the economic factors and provide evidence in support.
- In the case of **Apollo Sugar Clinics Ltd. vs. DCIT [2019] 105 taxmann.com 254 (Hyderabad - Trib.)**, the assessee-company is a second-level subsidiary of a Company in which public is substantially interested. The assessee-company issued the shares at the share premium of Rs. 990 per share and at Rs.1,220 per share in the first year of its operations and the allotments made to SSIL and AHLSL respectively. The Assessing Officer concluded that the valuation report submitted by the assessee for determination of share premium was imaginary with surmises and moreover there was very huge gap between the projections and actuals. Hence, the Assessing Officer determined the share premium under rule 11UA(1)(b) and disallowed the excess share premium collected under section 56 and added to the total income. ITAT held that since Holding company was a public limited company and by virtue of section 2(18), the assessee-company would be said to be a company in which public were substantially interested. Hence, the provisions of section 56(2)(viib) would not attract.

RELIEF FROM ANGEL TAX DEMAND

RELIEF FROM ANGEL TAX DEMAND – NOTIFICATION DATED 24 DECEMBER 2018

- CBDT has issued a notification, wherein it has directed the tax officers not to take coercive action in recovering outstanding tax demands in case of Start-Ups if additions have been made u/s 56(2)(viib) of the IT Act.
- While this came as a relief to the Start-ups facing significant tax demands, it was merely an informal and temporary step.
- The actual provisions of the section have not been amended and also the notices have not been revoked.
- Only the actual collection of demand has been temporarily halted.
- It appears that the Government did not want to collect any demands until it made up its mind on the way forward.

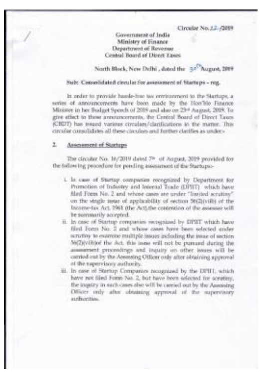
SCENARIO WITH EFFECT FROM 19 FEBRUARY 2019

- Pursuant to significant representation from the Start-up community, the Department for Promotion of Industry and Internal Trade (DPIIT) issued two notifications in quick succession which provided a blanket exemption to legitimate Start-ups, meeting the prescribed conditions, from operation of the above section.
- The key conditions (over and above the conditions for recognising the entity as a Start-up discussed in the definition section in slide 5) for availing the benefits from an Angel tax perspective are as under:
  - ✓ it has been recognised by DPIIT under para 2(iii)(a) or as per any earlier notification on the subject
  - ✓ aggregate amount of paid up share capital and share premium of the Start-up after issue or proposed issue of share, if any, does not exceed, INR 25 crore rupees
  - ✓ Further, this notification has tightened the belt by posing investment restrictions to be eligible for the angel tax exemption. Accordingly, Start-ups cannot invest in immovable property (other than its business use), extending loans and advances, investments in shares/ securities etc. for seven years from the date of issuing shares at premium. These prohibitions may hamper a Start-up's ability to invest its surplus funds.

NOTIFICATION DATED 9 AUGUST 2019 – RELIEF FOR INVESTMENTS PRE-19 FEBRUARY 2019

- Further to the above notifications, the Government has recently (i.e. on 9 August 2019) issued a clarification which provides that even if the assessment order has been passed on the eligible Start-up companies proposing an addition under the “Angel tax” provision (pre- 19 February 2019), the benefits of the circular dated 19 February 2019 will be available provided the conditions are met.

CIRCULAR NO. 22/ 2019 DATED 30TH AUGUST 2019 - ASSESSMENT OF START-UPS



Circular No. 22 /2019

Government of India
Ministry of Finance
Department of Revenue
Central Board of Direct Taxes

North Block, New Delhi , dated the 30th August, 2019

Sub: Consolidated circular for assessment of Startups – reg.

In order to provide hassle-free tax environment to the Startups, a series of announcements have been made by the Hon'ble Finance Minister in her Budget Speech of 2019 and also on 23rd August, 2019. To give effect to these announcements, the Central Board of Direct Taxes (CBDT) has issued various circulars/clarifications in the matter. This circular consolidates all these circulars and further clarifies as under:-

2. Assessment of Startups

The circular No. 16/2019 dated 7th of August, 2019 provided for the following procedure for pending assessment of the Startups:-

i. In case of Startup companies recognized by Department for Promotion of Industry and Internal Trade (DPIIT) which have filed Form No. 2 and whose cases are under "limited scrutiny" on the single issue of applicability of section 56(2)(viib) of the Income-tax Act, 1961 (the Act),the contention of the assessee will be summarily accepted.
ii. In case of Startup companies recognized by DPIIT which have filed Form No. 2 and whose cases have been selected under scrutiny to examine multiple issues including the issue of section 56(2)(viib)of the Act, this issue will not be pursued during the assessment proceedings and inquiry on other issues will be carried out by the Assessing Officer only after obtaining approval of the supervisory authority.
iii. In case of Startup Companies recognized by the DPIIT, which have not filed Form No. 2, but have been selected for scrutiny, the inquiry in such cases also will be carried out by the Assessing Officer only after obtaining approval of the supervisory authorities.

AMENDMENT IN FINANCE (NO.2) ACT 2019 - FOR START-UPS

START-UPS – AMENDMENT - FINANCE (NO.2) ACT 2019

- Capital gain tax exemption (arising on sale of residential property) for investment in start-ups by individuals/HUFs:
    - Extended up-to 31 March 2021.
    - Requirement of holding minimum 50% share capital / voting rights relaxed to 25%.
    - Lock-in period of 5 years on acquisition of computer/computer software purchased relaxed to 3 years.
- Carry forward and set-off losses available even on transfer of shareholding up-to 49%

COMPANY VS. LLP FOR START-UPS

COMPANY VS. LLP FOR START-UPS?

Particulars	Company	LLP
Taxable Income (A)	5,00,00,000	5,00,00,000
Tax Rate	25%	30%
Tax on it	1,25,00,000	1,50,00,000
Surcharge	8,75,000 (@7%)	18,00,000 (@12%)
Total	1,33,75,000	1,68,00,000
Cess @ 4%	5,35,000	6,72,000
Total tax payable (B)	1,39,10,000	1,74,72,000
Balance available (A-B)= C	3,60,90,000	3,25,28,000
DDT @ 20.56% (D)	74,20,104	0
Surplus (C-D)	2,86,69,896	3,25,28,000

THANK YOU

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