

Relief to start-up companies from Angel Tax

DPIIT issues notification to revise exemptions for start-ups under Section 56(2)(viib)

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Given its direct impact on availability of capital, taxation of start-ups on account of issuance of shares at a premium above the fair market value under Section 56(2)(viib) of the Income-tax Act, 1961 ("IT Act") – also referred to as Angel Tax – has been an issue of concern for the start-up sector for some time now. To alleviate these concerns, the Department for Promotion of Industry and Internal Trade ("DPIIT") has issued a Notification dated 19-02-2019 ("Notification") in supersession of earlier notifications dated 11-04-2018 as modified by another notification dated 16-01-2019.

At its core, there are three key aspects of this Notification: definition of start-ups (as per DPIIT); eligibility for claiming deduction under Section 80-IAC of the IT Act; and exemption under Section 56(2)(viib) of the IT Act. A few important aspects pertaining to these are set out below:

Definition of start-up expanded

The Notification provides that an entity shall be considered as a start-up:

1. Up to a period of 10 years from the date of incorporation/registration as a private limited company or a limited liability partnership. (earlier, this period was 7 years)
2. If the turnover of such an entity for any of the financial years since incorporation/registration has not exceeded INR 100 crores (earlier threshold was INR 25 crores in line with Section 80-IAC of the IT Act)
3. Such an 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

An entity shall cease to be a start-up on completion of 10 years from the date of its incorporation/registration or its turnover for any previous year exceeding INR 100 crores.

Certification for claiming deduction under Section 80-IAC of the IT Act

In order to obtain certification for the purposes of 80-IAC of the IT Act, an entity is required to fulfil the following conditions:

1. It should have been 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
2. It should have been incorporated on or after 01-04-2016 but before 01-04-2021
3. Turnover should not exceed INR 25 crores in the year in which the deduction is claimed

On fulfilment of the above conditions, an entity may obtain certification by filing an application in Form 1 with the Board. On receipt of application, the Board may either grant the certificate or reject the application.

Exemption under Section 56(2)(viib) of the IT Act

Section 56(2)(viib) provides that if a company receives any consideration for issuance of shares above FMV, then such a company will be liable to tax on the amount which exceeds FMV. For a start-up to be eligible for exemption under Section 56(2)(viib), the following conditions should be satisfied:

1. The company should be recognized by DPIIT
2. Aggregate amount of paid up share capital (including share premium), after the issue or proposed issue of shares, should not exceed, INR 25 crores (earlier this amount was INR 10 crores). This will not include shares issued to non-residents; shares issued to venture capital company or fund i.e. Category I Alternative Investment Fund; and shares issued or proposed to be issued to a "specified company".
3. A start-up should not have invested in the following assets for a period of 7 years from the end of the financial year in which the shares are issued at a premium:
 - Investment in land or building, residential house or otherwise, other than the one used for its business or renting or held as a stock in trade in the ordinary course of business

- Loans and advances, unless it has been extended in the ordinary course of its business, where lending the money is substantial part of its business
- Capital contribution in any other entity
- Investment in shares and securities
- Purchase of motor vehicle, aircraft, yacht or any other mode of transportation or jewellery, unless held in the ordinary course of business
- Any other asset, which includes - immovable property being land or building, shares and securities, jewellery, archaeological collections, drawings, paintings, sculptures, any work of art, bullion

If the start-up invests in any of the above assets before the end of 7 year duration, the exemption provided under Section 56(2)(viib) of the IT Act shall be revoked with retrospective effect. Upon fulfilment of the above conditions, a start-up shall file a declaration in Form 2 with the DPIIT, which will be forwarded to the CBDT. The exemption shall be applicable irrespective of the dates on which shares are issued by the start-up from the date of its incorporation. However, the exemption shall not be applicable to issuance of shares, where an addition has been made under an assessment order prior to the issuance of this Notification.

Our View

Upon a detailed analysis of the Notification and relevant provisions in IT Act, start-ups will be able to rest at ease only after the CBDT issues a notification to address several points of variance with DPIIT.

As an example, while the Notification extends the period for a company to be regarded as a start-up to 10 years, Section 80-IAC of the IT Act still has a 7 year duration (allowing start-ups to claim deduction for 3 consecutive years out of the 7 years from the year in which it is incorporated). Similarly, the increased turnover limit to INR 100 crore is at odds with the limit of INR 25 crore under Section 80-IAC; thus, , if the turnover exceeds INR 25 crores, the entity may not be regarded as a start-up for IT Act, unless the IT Act is amended to this effect

A similar situation exists with regard to exemption under Section 56(2)(viib) – one of the conditions to be eligible for exemption is that the start-up should be recognized by the DPIIT. This would mean that even though it may not satisfy the definition under Section 80-IAC to be eligible to claim deduction under this section, it may still be eligible to claim exemption under Section 56(2)(viib).

Lastly, the exemption benefit has not been extended to those companies where Assessment Orders have been passed prior to the date of issue of the Notification, which limits its applicability to start-ups.

All said, this notification is indeed a welcome step for the start-up sector in India. The Government will hopefully take concrete steps to address attendant deficiencies (the Notification shall come into effect on the date of its notification in the Official Gazette and the Central Government will carry out a review on or before 31-03-2021), in order to make this a meaningful exercise and help start-up companies access additional capital.



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