



# BHILAI BRANCH OF CIRC OF ICAI

VOLUME 09 | PAGES 9 | SEPTEMBER 2019



## E-NEWSLETTER

**Chief Editor**  
**CA. Shripal Kothari**

**Joint Editor**  
**CA. Ramandeep Singh  
Bhatia**

**Editorial Board**  
**CA Sourabh Goel**  
**CA. Bhushan Chipde**

Dear Esteemed Colleagues,

In the month of September most of the practising Chartered Accountants will be busy with Tax Audits. The move of Central Government to extend GST Annual Returns and GST Audit of Financial Year of 2017-18 to 30th November 2019 is a welcome measure. This will help the members to exclusively concentrate on Tax Audits in the month of September. The statistics revealed by CBDT that The Income Tax Department has registered a quantum jump in the e-filing of Income Tax Returns (ITRs) with an all time high of 49,29,121 ITRs filed in a single day on 31st August 2019 is a good sign. Tax payers are moving towards

compliance nation.

In this month of my writeup I would encourage members to spread government scheme of "Sukanya Smriddhi Scheme" for girl Children. The details of the scheme can be obtained from

[http://www.nsiindia.gov.in/InternalPage.aspx?Id\\_Pk=89](http://www.nsiindia.gov.in/InternalPage.aspx?Id_Pk=89). This scheme encourages regular payments to obtain a lumpsum amount at the age of 21 and also a part withdrawal for studies of the girl child at the age of 18.

I request the members to generously contribute to Chartered Accountants benevolent fund.

With Best wishes and warm regards,

**CA. NITIN RUNGTA**  
Chairman

Bhilai Branch of CIRC of ICAI



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

## TAX AND REGULATORY IMPLICATIONS ON START-UPS

Post liberalisation, privatisation and globalisation measures of 1991, India has emerged as an attractive investment destination for the world. With increase in per capita income, domestic investment has also increased tremendously. The technically advanced and skilled human resources of India and inflow of investments have encouraged a booming Start-up culture in India. Identifying the Start-up ecosystem as the new revenue and forex generating apparatus, the Indian Government has also joined hands in the Start-up development with various incentives and national programmes.

In the ensuing paragraphs, we have discussed the various tax and regulatory complexities surrounding the current Start-up ecosystem and thoughts on cutting through some of these complexities to enable doing business with ease and without encumbrances.

### What is a Start-up?

#### Generic definition

“A Start-up is a company working to solve a problem where the solution is not obvious and success is not guaranteed,” says Neil Blumenthal, cofounder and coCEO of Warby Parker.

Regulatory Definition As per Department for Promotion of Industry and Internal Trade (DPI&IT), Notification dated 19 Feb 2019, an entity shall be considered as a Start-up:

- Upto a period of ten years from the date of incorporation / registration, 1 G.S.R. 127 (E)

if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under Section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

- Turnover of the entity for any of the financial years since incorporation / registration has not exceeded one hundred crore rupees.
- 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'.

As per Section 80-IAC of the Income tax Act, 1961 ("the IT Act") which provides for Income-tax exemption for eligible Start-ups for the prescribed period.

"eligible start-up" means a company or a limited liability partnership engaged in eligible business which fulfils the following conditions, namely: —

- a) it is incorporated on or after the 1st day of April 2016 but before the 1st day of April, 2021;
- b) the total turnover of its business does not exceed twenty-five crore rupees in the previous year relevant to the assessment year for which deduction under sub-section (1) is claimed; and
- c) 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;

**Funding in Start-ups – Implications for Investors** Just as absence of oxygen ends life, in the same way an elixir of life for start-ups is funding. There is plethora of funding options available for start-ups which are discussed below:



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

1. **Equity investment:** India has allowed equity investment into almost all the sectors to make India an attractive investment destination. However, some sectors like insurance, retail, defence, etc. requires an approval and is subject to certain conditionalities. Further sectors like gambling, lottery business, chit funds & nidhi companies, manufacture of tobacco products/substitutes and real estate business, foreign investment is prohibited, in the interest of general public. The equity investment is the most desired way of investing by any investor since it provides with the voting power and ownership rights. There are certain variants of equity investment which are as follows:

- Equity shares/warrants
- Compulsory Convertible Preference Shares ('CCPS')
- Compulsory Convertible Debentur

The above instruments are especially useful in obtaining FDI for Start-ups. As per Indian Foreign Exchange Regulations, the above investments would qualify as FDI in India. 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. Pricing / conversion formula for CCPS / CCD should be determined upfront at the time of issue and not at the time of conversion. Certain prescribed filings with the authorized banker are also required. As per India Corporate law, 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. There are certain implications under the Income-tax Act in issue of equity which are discussed in the ensuing paragraphs. es ('CCD')

**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





# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

2. 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<sup>2</sup>. ECB can be raised only after obtaining the Loan Registration Number from RBI. Further annual compliance to RBI is to be done. 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. Convertible Notes specific to Startups: 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 state, this convertible note structure affords the necessary flexibility in structuring deals involving a dilution linked to milestones agreed or clawback for both investors and founders.

Implications on Redemption/ Repayment 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, appreciation etc.)



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

**The contentious Angel tax issue [56(2)(viib) of the IT Act]**

The “Angel tax” issue has actively debated and discussed by Start-ups and opposed vehemently. 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<sup>3</sup> 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.

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

The FMV for the purposes of this Section is to be determined as per the valuation Rules<sup>4</sup> prescribed. While the valuation formulae have been provided therein in detail, on a broad level basis the Rules provide for the FMV to be determined applying any of the following methods at the option of the Start-up company

- Net Asset Value Method
- Discounted Cash Flow Method; and
- Any other method which the company can substantiate to the satisfaction of the tax officer.



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

In a legitimate negotiated investment, where the investment value does not align with the valuation certificate, the Angel tax liability would arise upfront. Even where the investment value aligns with the valuation certificate, the “Angel tax” issue arose from the fact that the tax officer of the Start-up company has challenged the valuation carried out as per the valuation certificate submitted by the Start-up company.

Relief from Angel tax demand – notification dated 24 December 2018 Central Board of Direct Taxes (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 Startups 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 (formal as well as informal by way of social media posts, etc.) the Government has now taken definitive steps in providing the much-needed relief to Start-ups on this front. The Government [Department for Promotion of Industry and Internal Trade (DPIIT)] issued two notifications<sup>5</sup> in quick succession which provided a blanket exemption to legitimate Startups, 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 above) 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, twenty five crore rupees



# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

- 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<sup>6</sup> 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 198 February 2019 will be available provided the conditions are met.

As discussed above, the Start-ups are going to be the new age revenue generators and drivers of the global economy. Not only do they encourage entrepreneurship but also innovation and creativity. This innovation could bring in significant improvements in business and day to day life. The Start-up ecosystem is here to stay and business folks including consultants will do well to participate and contribute in this dynamic environment.





# BHILAI BRANCH

OF CENTRAL INDIA REGIONAL COUNCIL OF THE INSTITUTE OF CHARTERED  
ACCOUNTANTS OF INDIA

## UPCOMING EVENTS OF BHILAI BRANCH OF CIRC OF ICAI

11.10.2019 : LIVE WEBCAST ON KEY ISSUES IN IMPLEMENTATION OF  
IND AS FOR NBFC

21.10.2019 : LIVE WEBCAST ON "TDS u/s 195 & 15CA/CB  
CERTIFICATION"

