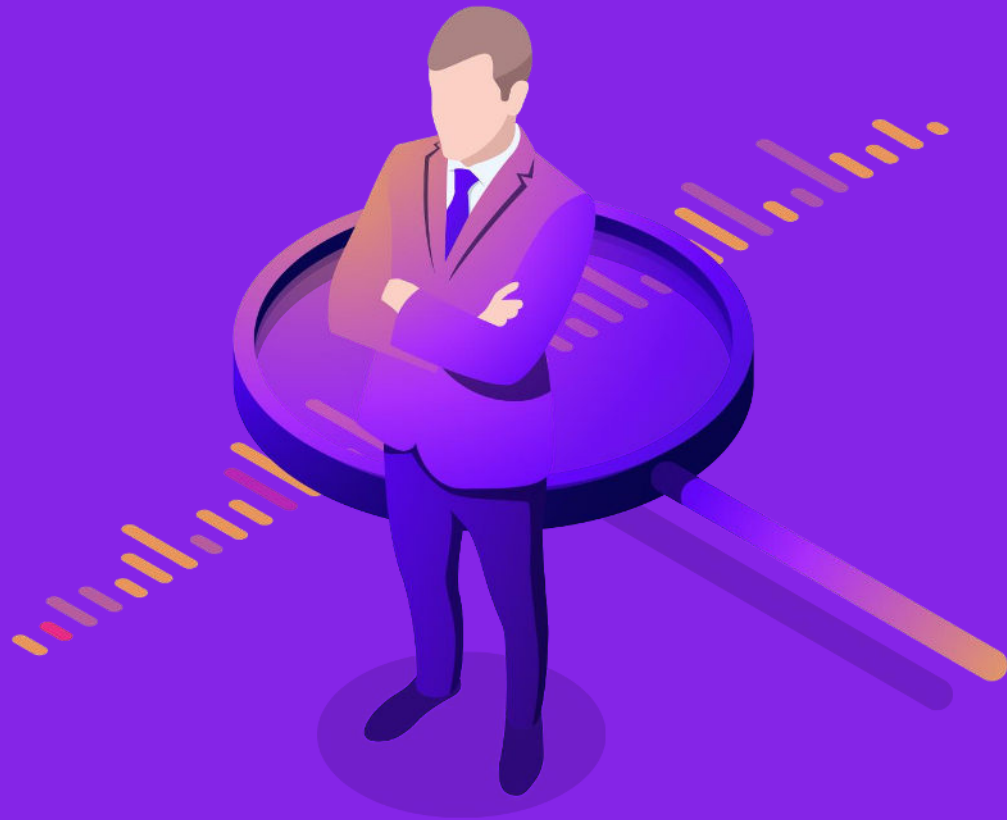




Tax Implications In India On Startups & Investors



May 2023





Purpose Of The Document












The purpose of this document is to highlight the direct tax implications which are particular to the startup ecosystem in India – covering startups and investors both.



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 Abbreviations	04
Section 1 For Startups	Section 2 For Investors
 Angel Tax	 Shares Received At No Cost Or At Less Than FMV
 Tax Holiday	 Capital Gains On Transfer Of Shares
 Unexplained Cash Credits	 Capital Gains Exemption To Boost Investment In Startups
 Taxability Of Patent Income, Carry Forward Of Losses...	 ESOP Taxation In The Hands Of Employees

Abbreviations



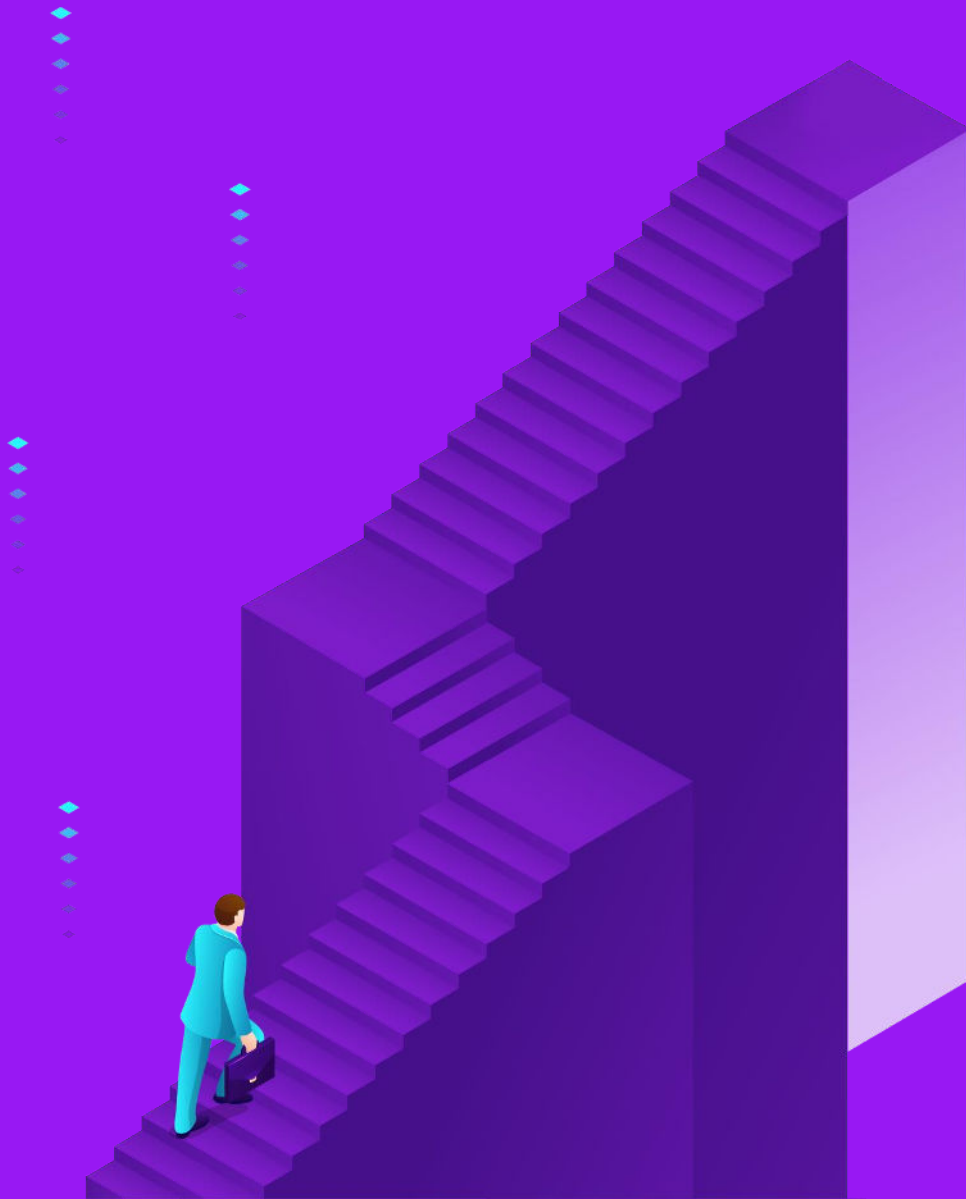
AIF	–	Alternate Investment Fund	INR	–	Indian Rupees
AO	–	Assessing Officer	ITA	–	Income-tax Act, 1961
CBDT	–	Central Board of Direct Taxes	ITR	–	Income Tax Return
DCF	–	Discounted Cash Flow	IT Rules	–	Income-tax Rules, 1962
ESOP	–	Employee Stock Option Plan	LLP	–	Limited Liability Partnership
FDI	–	Foreign Direct Investments	MOA	–	Memorandum of Articles
FMV	–	Fair Market Value	MSME	–	Micro, Small and Medium Enterprises
FY	–	Financial Year	NAV	–	Net Assets Value
IFSC	–	International Financial Services Centre	RSE	–	Recognized Stock Exchange
ITA	–	Income-tax Act, 1961	VC	–	Venture Capital/ Capitalist
IMB	–	Inter-Ministerial Board of Certification			



Section 1 For Startups

Topics discussed herein:

- Angel Tax
- Tax Holiday For Startups
- Unexplained Cash Credits
- Taxability Of Patent Income, Carry Forward Of Losses..





Angel Tax



Topics discussed herein:

- *What Is Angel Tax?*
 - *Who Can Avail Angel Tax Exemption?*
 - *How To Avail Angel Tax Exemption?*
-



What Is Angel Tax?



Applicability

- Applicable on private limited companies and unlisted public limited companies, where less than 50% of the voting power is held by the government or a corporation established by a Central, State or Provincial Act.

Trigger point

- Such company receives any consideration for issue of shares that exceeds the face value from any person (whether tax resident/non-resident in India).

Consequence

- Taxable in the hands of such company

What is taxable?

- Aggregate consideration which exceeds the FMV

Non-applicability of this section

- If received by VC undertaking from:
 - a VC company, or a VC fund, or AIF (Category I & II), or fund regulated under IFSC.
- If received by a recognized startup company subject to fulfillment of prescribed conditions [[Notification No. 30/2023](#) dated 24 May 2023] (prescribed conditions discussed in the ensuing section; refer page # 9 and 10)
- If received from following class or classes of persons: [[Notification No. 29/2023](#) dated 24 May 2023]
 - Government and government related investors including entities controlled by the Government or where direct or indirect ownership of the Government is seventy-five percent or more;
 - Banks or entities involved in Insurance Business;
 - Following entities that are resident of 21 specified jurisdictions ([refer next slide for list of specified jurisdictions](#)):
 - Entities registered with SEBI as Category-I Foreign Portfolio Investors,
 - endowment funds associated with university, hospitals or charities,
 - pension funds created under the law of the foreign country or specified territory,
 - Broad Based Pooled Investment Vehicle or fund with not more than fifty investors (other than hedge fund or a fund which employs diverse or complex trading strategies.



What Is Angel Tax?



Non-applicability of this section ...contd.

List of specified jurisdictions:

- Australia
- Austria
- Belgium
- Canada
- Czech Republic
- Denmark
- Finland
- France
- Germany
- Iceland
- Israel
- Italy
- Japan
- Korea
- New Zealand
- Norway
- Russia
- Spain
- Sweden
- United Kingdom
- United States

Determination of FMV

Higher of:

- As determined under Rule 11UA(2) of the IT Rules (see below);
- Book value of its assets on the date of issue of shares as may be substantiated by the company to the satisfaction of the Assessing Officer.

Calculation under Rule 11UA(2) of the IT Rules¹

At the option of the Assessee

- NAV, or
- DCF value determined by a merchant banker.

Such FMV is to be determined as on date on which consideration is received by the Assessee.

¹ Vide recent [notification F.No. 370142/9/2023-TPL \(Part-I\) dated 26 May 2023](#), the CBDT has proposed to amend Rule 11UA(2) to include other internationally accepted methods for valuation of equity shares and has also proposed safe harbour of 10%. The -DRAFT- rules have been released for inviting public comments by 5 June 2023. Therefore, the method of equity share valuation may undergo some change.



Who Can Avail Angel Tax Exemption?

- A startup shall be eligible for exemption from applicability of section 56(2)(viib) if it fulfils the following conditions * :
 - **It is a DPIIT-recognized startup**
 - **Aggregate paid up share capital + share premium (after issue or proposed issue of share, if any) - Up to INR 25 Crore**

Following persons shall not be included for calculating the share capital and share premium amount:

- a non-resident; or
 - a venture capital company or a venture capital fund; or
 - specified company**
- Exemption available if funds are utilized for legit business purposes and not for acquiring specific assets.
 - It has not invested in any of the specified assets for 7 years from the date of latest financial year in which shares are issued at premium.
 - The list of specified assets include:
 - **residential house unless the startup is in that business and uses it for the purposes of renting or held by it as stock-in-trade;**
 - **any land or building, or both (not being a residential house) unless occupied by the startup for carrying out its business or used by it for purposes of renting or held by it as stock-in trade, in the ordinary course of business;**

* As per Gazette Notification No. 127 (E) dated 19 February 2019 issued by the DPIIT

** Specified company – Company whose shares are frequently traded within the meaning of SEBI Regulations AND whose net worth as on 31st March of preceding FY exceeds INR 100 crore or turnover for preceding FY exceeds INR 250 crore.



Who Can Avail Angel Tax Exemption?

- The list of specified assets include (...contd.):
 - **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 INR 10 Lakh, unless it is held by the startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business;**
 - **jewelry other than that held by the startup as stock-in-trade in the ordinary course of business;**
 - **any other asset including drawing, paintings, sculptures, etc.**



How To Avail Angel Tax Exemption?

- A startup is required to file a declaration under Form – 2 with the DPIIT to certify and declare that all the prescribed conditions to avail this angel tax exemption have been duly fulfilled.
- Declaration is required on the letterhead of the startup company.
- Declaration is required to be signed by a person who is authorized to verify the return of income under the Act.
- Following particulars are required in the declaration form:
 - **Name, PAN and designation of the person authorizing the declaration form**
 - **PAN of the startup company**
 - **DPIIT registration number**
- The DPIIT, on receiving the same, shall forward it to the CBDT.

Revocation of Angel Tax Exemption

- Any false declaration under Form – 2 may retrospectively revoke the angel tax exemption.
- Any investment in the restricted assets within 7 years from the latest FY in which the shares are issued at premium.

Time limit for filing declaration to avail Exemption

Anytime irrespective of the dates on which shares are issued by the Startup from the date of its incorporation, except for the shares issued in respect of which an addition under section 56(2)(viib) of the Act has been made in an assessment order made under the Act before the date of issue of the notification.

Key Takeaway

Angel tax exemption is a welcome step given that there was an unnecessary litigation at this front. However, the conditions of specified assets are too rigid, especially the restriction on any startup to make capital contribution in any other entity. In short, it does not allow holding subsidiary structure for a startup. Therefore, any similar existing structure requires a revisit from angel tax perspective. Furthermore, bringing non-resident investors also in this ambit, w.e.f. 1 April 2023, the scope has been widened and does not align with the ease of doing business intention of the Government.



Tax Holiday

Topics discussed herein:

- *Who Can Avail Tax Holiday?*
 - *How To Avail Tax Holiday?*
-



Who Can Avail Tax Holiday?

Background

To provide impetus to new entrepreneurial ventures, business profits earned by eligible startups carrying on eligible business are entitled to claim tax holiday of any 3 block years out of first 10 years of the startup

Applicability

- Applicable to eligible startups carrying on eligible business
- Only business profits are exempt
- Business profits for any 3 consecutive years during the first 10 years since incorporation of start-up.

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.

Eligible Start-up

Means a company or an LLP engaged in eligible business which fulfils the following conditions, namely:

- it is incorporated on or after the 1st day of April 2016 but before the 1st day of April 2024;
- the total turnover of its business = Up to INR 100 crore in the relevant FY; and
- it holds a tax holiday certificate granted by the IMB.

Additional Conditions

- Such startup should not be formed by splitting up, or the reconstruction of an existing business
- Such startup is not formed by transfer of used (second-hand) plant or machinery



Who Can Avail Tax Holiday?

Deemed unused plant or machinery in the following cases:

- Already used + outside India + by anyone except the Assessee and:
 - Imported into India
 - No depreciation claimed previously under the provisions of the IT Act by anyone prior to the installation by the Assessee
- Up to 25% of total value of plant or machinery is previously used (second-hand).

Note: Startup availing tax holiday is still required to pay minimum alternate tax (MAT) at the rate of 15% plus applicable surcharge and cess.



How To Avail Tax Holiday?

Procedure to apply for tax holiday

- File Form – 1 with the IMB, along with the prescribed documents (see below).
- Prescribed documents include:
 - Copy of MOA,
 - Copy of LLP/partnership deed,
 - Copy of board resolution,
 - Annual accounts of the startup for the last three financial years,
 - Copies of income-tax returns for the last three financial years, wherever applicable.
- The CBDT, upon receiving the application along with the prescribed documents/information, may issue the desired certificate or reject the application specifying the reasons of rejection.

Revocation of tax holiday

- In case it is found that any certificate under this section has been obtained on the basis of false information, the CBDT reserves the right to revoke such certificate or approval and it shall be deemed to have been never issued/granted.

Key Takeaway

Ideal incentive for any profit-making startup. However, the tax holiday should be allowed for 5 years instead of the current period of 3 years.



Unexplained Cash Credits



Topics discussed herein:

- *Applicability*
 - *Trigger point*
 - *Consequences*
 - *Key takeaway*
-



Unexplained Cash Credits



Applicability

- Any Assessee (individual or non-individual + resident or non-resident)

Trigger point

- Any sum found credited in the books of accounts and no explanation is offered regarding its nature and source, or such explanation is not satisfactory in the opinion of the AO.

Consequences

- The sum so credited will be charged to tax at a special flat rate of 60% (plus applicable surcharge and cess) in the relevant FY.

In the following case, it shall be deemed that the explanation offered is unsatisfactory:

- Assessee = Company + in which public not substantially interested*, i.e., private limited companies and unlisted public limited companies where the less than 50% of the voting power is held by the government or a corporation established by a Central, State or Provincial Act

and

- The sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called

unless

- The payer is a resident (individual or non-individual) + offers an explanation about nature and source of such sum so credited

and

- AO finds such explanation to be satisfactory
- The above deeming fiction will not apply if the investor is a venture capital fund or a venture capital company as referred to in clause (23FB) of section 10.

* Refer section 2(18) of the IT Act for the definition of company in which the public are substantially interested



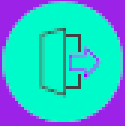
Unexplained Cash Credits

Key Takeaway

This section can have wide ramifications for startup companies. Currently, no exemption is available to startup companies. Hence, it is imperative to ensure genuineness of investors and make possible efforts to see that the invested funds are not from scrupulous channels.



Patent Income, Carry Forward of Losses...



Topics discussed herein:

- *Lower Taxation On Patent Income*
 - *Carry Forward And Set Off Of Losses*
 - *Implications On Carry Forward of Losses In Case Of Delayed Filing of ITR*
-



Patent Income, Carry Forward Of Losses And Timely Filing Of Return Of Income

Lower Taxation On Patent Income

To promote development and registration of patents in India, a simplified scheme has been introduced for taxing royalty income from patents which are developed and registered in India. Such royalty income will attract tax at a reduced rate of 10 per cent.

Carry Forward And Set Off Of Losses

Eligible startups are allowed to carry forward losses incurred during the initial ten years starting from the year of incorporation even if there is a change in its voting rights exceeding 49 per cent, provided that the shareholders who held shares carrying voting power on the last day of the year in which the loss was incurred continue to hold those shares on the last day of the previous year in which the losses are to be set-off. This has been done to enable startups to raise funds in form of equity shares without any adverse income tax consequences.

Implications On Carry Forward of Losses In Case Of Delayed Filing of ITR

Amongst other provisions of filing the ITR, it is pertinent to note that since the startups usually incur losses in the initial years of operations, the carry forward and set off of losses can only be made if the ITR is filed within the prescribed due date.



Section 2 For Investors

Topics discussed herein:

- Shares Or Securities Received Without Consideration Or At Less Than FMV
- Capital Gains On Transfer Of Shares
- Capital Gains Exemption
- ESOP Taxation





Shares Or Securities Received Without Consideration Or At Less Than FMV



Topics discussed herein:

- *Applicability*
 - *Trigger point*
 - *Consequences*
 - *What is taxable?*
 - *Determination of FMV*
-



Shares Or Securities Received Without Consideration Or At Less Than FMV

Applicability

Applicable on any person receiving from any person (individual or non-individual; resident or non-resident)

Trigger point

Any person receiving shares or securities

- without consideration where FMV exceeds INR 50,000 or
- at a discount to FMV* where the discount exceeds INR 50,000.

Consequences

Taxable as income from other sources in the hands of the investor

What is taxable?

- Where no consideration paid → Entire FMV
- Where consideration paid → FMV less actual consideration

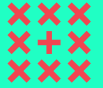
Determination of FMV (As per 11UA of the IT Rules)

FMV = NAV**

Notes

**Issuance at discount to FMV is restricted under the Indian foreign exchange regulations for FDIs by non-resident investors. However, this section could get triggered in case of resident investors.*

***NAV is to be determined as on the date on which the property or consideration is received*



Capital Gains On Transfer Of Shares



Topics discussed herein:

- *Applicability*
 - *Trigger point*
 - *Consequence*
 - *Determination of FMV [As per Rule 11UAA read with Rule 11UA]*
-



Capital Gains On Transfer Of Shares

Applicability

Any Assessee (individual or non-individual; resident or non-resident) transferring shares other than the ones quoted on any RSE

Trigger point

Investor receives consideration which is less than FMV

Consequence

- Sales consideration less cost of acquisition/cost of improvement and expenditure incurred (wholly and exclusively in connection with such transfer) shall be chargeable to tax as Capital Gains.
- FMV of the shares shall be deemed to be the sales consideration in case sales consideration is less than FMV.

Determination of FMV [As per Rule 11UAA read with Rule 11UA]

- For equity shares → NAV
- For preference shares → Based on price it would fetch in the open market. Obtain a report from a Merchant Banker or a Chartered Accountant

Such FMV will be determined as on the date of transfer of shares.



Capital Gains Exemption To Boost Investment In Startups

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Topics discussed herein:

- *Background*
 - *Applicability*
 - *Lock-in period*
 - *Eligible startup and eligible business*
 - *Eligible company*
 - *Meaning of new assets*
-



Capital Gains Exemption To Boost Investment In Startups ¹

Background

To boost the investment in eligible start-ups, a new exemption offered to taxpayers (individual or HUF only) from long-term capital gains arising from the transfer of residential property.

Applicability

- Available only to individual or HUF + investing in equity shares of an eligible company.
- Available only on long-term capital gains (net consideration) earned from sale of residential property (house or plot of land).
- Such net consideration to be utilized on or before the due date of furnishing the ITR.
- The startup should utilize the subscription amount for procuring new assets (see below) within one year from subscription of shares by the taxpayer.

Lock-in period

- The investee company cannot sell such new assets and the investor cannot sell the shares of startup company for at least 5 years from the date of respective acquisitions.
- However, if the new asset comprises of computer or computer software then the lock-in period for the investee company shall be 3 years.

Eligible startup and eligible business

Both shall have the same meaning as defined under section [80-IAC](#) of the IT Act

¹ This exemption shall not apply to any transfer of residential property made after 31 March 2022.



Capital Gains Exemption To Boost Investment In Startups ¹

Eligible Company

Incorporated in India during the relevant FY in which the capital gain arises to the due date of filing return of income.

- Engaged in
 - business of manufacture of an article or a thing, or
 - in an eligible business
- It is a company in which the Investor Assessee holds > 25% share capital or voting rights after subscription in shares.
- It is a company which qualifies as an MSME under the MSME Act, 2006 or is an eligible start-up.

New Assets

Means new plant and machinery but does not include:

- Second-hand plant or machinery used in or outside India
- Already used plant or machinery by the Assessee himself
- Any office appliances
- Computer or computer software (unless it is a technology driven startup)
- Any vehicle
- Fully depreciated/written off plant or machinery

¹ This exemption shall not apply to any transfer of residential property made after 31 March 2022.



ESOP Taxation In The Hands Of Employees



Topics discussed herein:

- *Background*
 - *Trigger Points For Taxability*
 - *Calculation of FMV*
-



ESOP Taxation In The Hands Of Employees

Background

ESOP allows an employee to own equity shares of the employer company over a certain period. ESOPs have recently gained popularity in India especially in the startup space. Since the startups are operating with limited liquidity, at least, in the initial stages, they attract talent with comparatively less payout in cash with an option to purchase the equity shares of the company at a later stage decided based on mutual agreement.

Before we venture into the ESOP taxation, it is pertinent to familiarize ourselves with the specific terminologies used under ESOP.

Grant Date – The date of agreement between the employer and employee to give an option to own shares (at a later date).

Vesting Date – The date the employee is entitled to buy shares, after prescribed conditions (mutually agreed upon) are fulfilled. This date is also the agreed-on grant date.

Vesting Period – The time period between the grant date and vesting date.

Exercise Period – Once stocks have 'vested', the employee now has a right to buy (but not an obligation) the shares for a period of time. This period within which an employee can exercise its option is called exercise period.

Exercise Date – The date on which employee exercises the option.

Exercise Price – The price at which employee exercises the option.

Exercise price is usually lower than the prevailing FMV of the stock. An employer and employee agree on ESOP terms on the grant date. Once the employee has fulfilled the conditions or the relevant time period has elapsed, these employee stock options are vested. At this time the employee can exercise them or put simply – buy them. The employee is allowed some time period during which this option to buy can be exercised. Once the employee decides to buy, these stock options are allotted to him at an exercise price which is usually lower than the FMV of the stock. Of course, the employee can choose not to exercise his option.



ESOP Taxation In The Hands Of Employees

Trigger Point For Taxability

There are two trigger points for ESOPs to be taxed –

1. At the time of exercise → Taxable as a perquisite under the head 'salary'

What is taxable? → Difference between the FMV (on the exercise date) and exercise price is taxable as perquisite. The employer deducts TDS on this perquisite. This amount is shown in the employee's Form 16 and included as part of total income from salary in its ITR.

Exception for eligible startups

An employee receiving ESOPs from an eligible start-up need not pay tax in the year of exercising the option. The TDS on the 'perquisite' stands deferred to earlier of the following events:

- 5 years from the year of allotment of ESOPs
- Date of sale of the ESOPs by the employee
- End of employment with the eligible startup

Eligible startups shall have the same meaning as defined under [section 80-IAC](#) of the IT Act

2. At the time of sale by employee → Taxation as capital gain

What is taxable? → Difference between sale price and FMV (on the exercise date) is taxed as capital gains in the hands of the employee

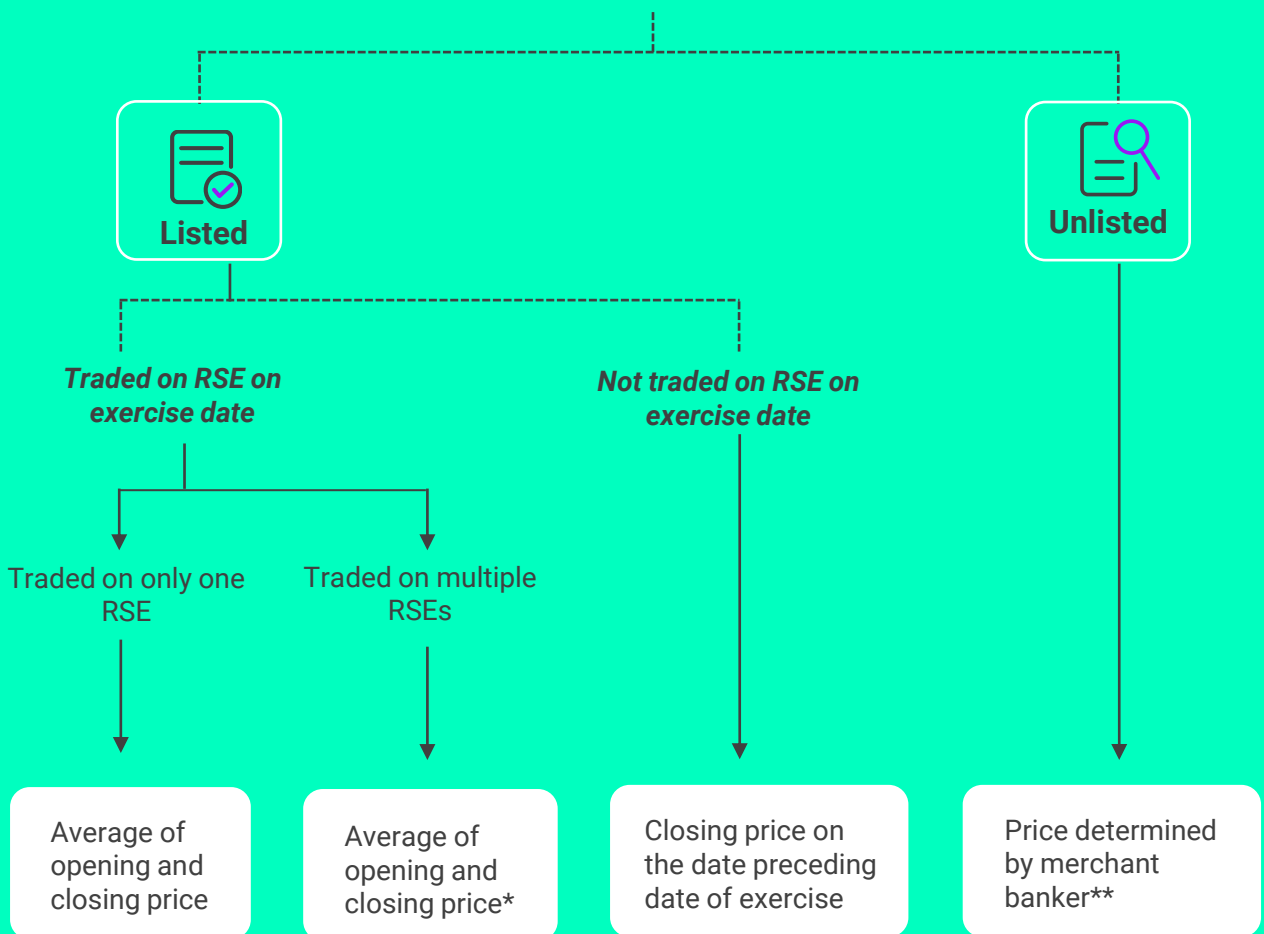
ESOP Taxation In The Hands Of Employees



Calculation of FMV



SHARES



* Which records highest volume of trading in shares

** Price to be determined as on the exercise date or any earlier date upto 180 days prior to the exercise date.



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