

## Budget 2023: Start-ups Wishlist From Tax and Regulatory Perspective

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India has emerged as the 3rd largest ecosystem for start-ups globally with over 84,000 DPIIT-recognized start-ups across the country<sup>[1]</sup>. Indian Start-up ecosystem has seen an exponential growth in past few years. Indian start-ups attracted about USD 112 billion investment in the 8 years alone and have directly created millions of jobs in the country<sup>[2]</sup>. The collective valuation of these start-ups is more than USD 400 billion. The sector has achieved scale and is a crucial link between growth, innovation, employment, and foreign trade.

However, during 2021, most of the industries were abruptly impacted due to pandemic and the major victims of the same were budding businesses i.e., especially start-ups. In February 2022, with the beginning of Russia-Ukraine war, all the equity markets across the globe came under pressure. Further, the Central Bank raised interest rates, resulting in liquidity crunch. The Start-ups which were planning to list then had to rethink their plans. The overall funding in the Indian Start-ups have witnessed 33% reduction as compared to 2021<sup>[3]</sup>.

Amongst others, start-ups have been the key drivers in the growth of the Indian Economy. In order to initiate the development of start-ups in India and provide a competitive platform for businesses which are newly established to thrive amidst the aggressive business atmosphere, the Government of India has brought in various tax and regulatory benefits since a past few years. Out of various incentives, some of the key benefits involved 100% deduction against profits for 3 consecutive years out of the 7 years beginning from the year of incorporation (subject to approval from Inter Ministerial Board); angel tax exemption (subject to fulfilment of certain conditions), ease of norms for carry forward and set of tax losses on account of change in shareholding; deferred taxation of ESOPs with regard employees of start-ups and so on.

While the budget date is approaching soon, the start-up community is eagerly looking forward for beneficial tax and regulatory proposals from the Finance Minister of India. In order to recoup the slowdown as to what has been termed as 'winter season of funding' for start-ups, easing out / providing clarity to certain provisions / incentives from tax and regulatory perspective may provide impetus to Start-ups. In our view, following are the wishlist of the start-ups from Union Budget 2023 from a tax and regulatory standpoint.

### **Wishlist of Start-ups from Tax and Regulatory perspective**

#### **1. Carry forward of Losses**

The Government, pursuant to the start-up action plan and to facilitate ease of doing business, introduced a beneficial regime for eligible start-ups to carry forward and set off losses. Specifically for the eligible start-ups, proviso to section 79 of the Income-tax Act, 1961 ('the Act') provides that as long as all the shareholders of the taxpayer, at the end of the financial year in which the loss was incurred continue to hold such shares in the financial year in which the loss is to be set off, the benefit of carry forward of loss would be available.

Considering that shareholding of start-ups are floating majorly because of generous funding by angel investors who are willing to take business risks, generally wish to exit the start-up after 2-3 years by selling out their stake at higher value. Investors or entrepreneurs with extensive experience in the start-up world, invest in start-ups in exchange for a brand's equity. Looking at the business strategy of these angel investors, any such exit will trigger section 79 limitation for the start-up company.

The condition of continuing to hold shares appears to be applicable not only to the initial promoters but also to all persons investing subsequently in the start-up, which may cause genuine practical hardship.

#### **Wishlist:**

#### **Removal of condition of continuity of shareholding**

Accordingly, in order to boost investment in start-ups and avoid genuine hardship, it would be very relevant to ease the provisions for carry forward of losses of start-ups due to change in shareholding. Possibly, provisions of section 79 of the Act can be amended to remove the condition of continuous holding (being persons holding shares in the year of loss). Regardless of the above, it can be amended to provide that if the start-up crosses the prescribed turnover criteria after prescribed years of incorporation, the provisions of section 79 of the Act as applicable to other companies would apply to such start-ups. In this manner, the start-ups which are at incubation stage and in growth phase can carry forward the losses and the ones which have established itself, atleast in terms of revenue sales, would not be subjected to contours of a start-up in real sense.

#### **Extension of the time period for carry forward of losses**

In the case of budding start-ups, there is usually a prolonged gestation period i.e., it takes time to stabilise revenue and earn profits. At most of the times, while it starts to earn profits, the period of setting-off of losses gets expired. Accordingly, carry forward and set-off of losses can be extended to 15 years instead of the current limitation of 10 years.

#### **2. Taxation of ESOPs**

In case of employees receiving ESOPs from eligible start-ups (i.e., start-ups set up on or after 1 April 2016 and approved by Inter Ministerial Board ('IMB') for claiming benefit under section 80-IAC of the Act), the point of taxation has been deferred to a future date i.e.

1. 5 years from the year of allotment of ESOPs; or
2. Date of sale of the ESOPs by the employee; or
3. End of employment with the eligible start-up; whichever is earlier.

However, this exemption is available only to eligible start-ups.

**Wishlist:****Extension of coverage of eligible start-ups**

Majority of tax benefits for start-ups are available only after obtaining approval from IMB. However, the process of obtaining certificate from IMB is onerous such that very few start-ups are recognised by IMB and, rest are just recognised by DPIIT. Therefore, benefit of ESOP tax deferral should be extended to all start-ups registered with DPIIT even though not recognised by IMB. This would indirectly promote employment and investment in start-ups.

**3. Turnover limit under section 80-IAC** of the Act

Section 80-IAC of the Act provides for 100% deduction in profits to the eligible start-ups, for 3 consecutive years out of 7 years from the date of incorporation. As per section 80-IAC, an “eligible start-up” means a company or a limited liability partnership engaged in eligible business which fulfils the following conditions, namely:—

1. it is incorporated on or after the 1 April 2016 but before the 1 April, 2023;
2. the total turnover of its business does not exceed INR 10 million in the previous year relevant to the assessment year for which deduction under sub-section (1) is claimed; and
3. it holds a certificate of eligible business from the IMB of Certification as notified in the Official Gazette by the Central Government.

**Wishlist:****Extension of coverage of eligible start-ups**

As mentioned above, although majority of the start-ups are recognised by DPIIT but very few of them have been able to obtain certificate from IMB. Therefore, it is essential to pass on this benefit to all start-ups whether recognised by IMB or not. Accordingly, the condition of IMB certification should be done away with.

**Extension of period of benefit**

Further, as evident from the wording of the provision, the profit linked deduction under section 80-IAC of the Act is available only to the entities incorporated before 1 April 2023. In order to fuel impetus to the start-ups, it would be necessary to extend this benefit by atleast 2 years.

**4. Conversion of convertible notes into shares**

Start-ups issues various instruments to the investors depending on the objective of the transaction or arrangement. With the Reserve Bank of India ('RBI') permitting a person resident outside India to purchase Convertible Notes ('CNs') issued by an Indian start-up company (subject to certain conditions), the Indian start-ups can now issue CNs to both resident as well as to non-resident investors.

These CNs are typically converted into equity shares at a later date, as agreed between the parties. As per the extant provision of section 47(x) of the Act, conversion of bonds or debentures or debenture stock or deposit certificate in any form, into shares or debenture of that company is exempted from capital gains tax liability. However, the conversion of CNs issued by an Indian start-up into shares or debentures is not specifically exempted.

**Wishlist:****Exemption on conversion of CNs into equity**

Some of the angel investors invest through debt mode instead of equity, to minimise their risk. However, on achievement of satisfactory growth in the start-ups, they may demand for conversion of CNs into equity. Therefore, to bring CNs at par with other quasi-equity instruments, it is expected that a specific exemption should be provided under section 47 of the Act for its conversion into equity.

## **5. Angel Tax Exemption**

As per section 56(2)(viib) of the Act, when a closely held company issues shares to a resident person, at a price which is more than its fair market value, then the consideration as received from issue of shares in excess of its fair market value is charged to tax under the head 'Income from other sources'. Tax on income arising under section 56(2)(viib) of the Act is also referred to as "Angel Tax".

In order to exempt start-ups from the implications of section 56(2)(viib), the Government issued a notification dated 19 February 2019 stating that provisions of section 56(2)(viib) of the Act shall not apply to start-ups on fulfilment of certain conditions.

### **Wishlist:**

#### **Extension of the threshold of turnover**

Amongst others, one of the conditions for availing angel tax exemption is that the aggregate amount of its paid-up share capital and share premium of the start-up after issue or proposed issue of shares does not exceed INR 2.5 million. This condition poses constraint on expanding capital base of the start-ups and curtails new possible investments. Accordingly, to support the start-up ecosystem from funding perspective, the threshold limit of turnover should be extended to INR 10 million in line with DPIIT norms.

#### **Relax capital contribution norm in other entities**

Angel tax exemption is not available to the start-ups investing their funds in shares and securities of other entities. This again creates obstacles for companies, looking to expand / grow inorganically through mergers and acquisitions or setting up of subsidiaries. Therefore, it is expected that this condition should be omitted / relaxed.

## **6. Tax Neutrality under Outbound Merger**

One of the possible route for Indian start-ups to list overseas is merger of the Indian start-up with Special Purpose Acquisition Company, which has been listed on the exchanges overseas. The current corporate law and Foreign Exchange Management Act ('FEMA') provisions allow outbound merger of Indian companies with Foreign companies, albeit, the said structure has many implications. One such implications is that the extant income tax provisions do not regard such outbound merger as tax neutral.

### **Wishlist:**

#### **Exemption under section 47 of the Act for outbound merger of Indian start-ups**

It is expected that merger of Indian eligible start-up with a foreign Company should not be regarded as transfer under section 47 of the Act.

## **7. Notification of Funds for exemption under section 54EE of the Act**

In order to promote the start-ups and to provide tax incentive for investment in notified funds, Section 54EE of the Act was inserted wherein long-term capital gains would be subject to exemption if invested by a taxpayer in units of notified fund.

### **Wishlist:**

#### **Notification of funds**

It is expected that specified fund under section 54EE of the Act should be notified at the earliest so that exemption can be claimed by investing the amount in the units of such fund as envisaged.

## **8. Foreign Direct Investment in start-ups**

As per Press-note 3/ 2020 issued under Foreign Direct Investment Policy, it requires that all investments

from entities, which are based in a land-bordering country, or when the beneficial owner of the investment is resident / citizen of a land-bordering country, then the said investment will have to be made under the 'approval route' and will require security-clearance. The Press Note do not provide any clarity on what constitutes beneficial shareholding.

Consequently, various large Private Equity/Venture Capital funds, who would have investors in their pool from these land bordering countries are also covered by this, even if the % holding in those funds by such set of investors is minimum and are required to obtain Government approval before investing in the Indian entities.

#### **Wishlist:**

#### **Removal of approval route for certain investors / defining limit of the ultimate beneficial owners**

The Government can re-look at the current FEMA provisions and if found appropriate, may grant exemption from the requirement of obtaining prior Government approval to certain cases of investments by foreign investors in Indian entities where substantial beneficial owner / ultimate beneficial owner are not situated from the land bordering countries.

#### **Conclusion**

Indian Government has been empowering start-ups through various means to cope up with the economy. Moreover, many start-ups have registered themselves under start-up India regime so as to get maximum benefits from the Government. As the result of this, more and more entrepreneurs are getting motivated to bring innovation, build their own ventures and contribute towards development of society and economy as a whole. To provide impetus to start-ups, the Indian Government may put forth additional tax and regulatory proposals in the Union Budget 2023 which would be for the betterment of the start-ups.

\* The views expressed in this article are personal view of these authors and do not resemble any professional advice from the organization.

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[1] Source: <https://pib.gov.in/PressReleaseframepage.aspx>

[2] <https://economictimes.indiatimes.com>

[3] <https://www.ndtv.com/business/startup-funding-in-india>