Taxing for start-ups

The conditions for getting Angel Tax exemption

HITEN KOTAK / ADITYA NARWEKAR

A new provision, Section 56(2)(viib) of the Income Tax Act, was introduced in the 2012 Union Budget to tax untenable share premium over and above the fair market value (FMV), which was widely used as a means for circulating unaccounted money.

This provision, popularly referred to as 'Angel Tax', prescribes a valuation methodology for determining the FMV of shares issued. The FMV for this purpose is higher of the following: value determined as per the formula under the income tax rules or discounted cash-flow method, at the option of the taxpayer; or any such value substantiated by the taxpayer to the satisfaction of the assessing officer.

This provision is applicable only to shares issued by closely-held companies to resident Indians. However, a certain category of investors — including venture capital funds and specific funds — are exempt from the applicability of this provision.

Start-up exemption

Generally, companies issue shares at a premium with a view to fortify their capital base, and such premium is based on the commercial negotiations between the investors and the companies. Typically, the investors agree to a premium (especially in the case of start-ups) in anticipation of the unique products/ideas materialising into an established business in the future.

Many start-ups received notices from the tax authorities questioning the valuation methodology used for determining the FMV of shares. Consequently, the issue that arose was whether the authorities had the right to do so. Contrary views have been adopted on this subject by different judicial and quasi-judicial authorities.

While the rulings are fact-specific, the key principle emanating was that the assessing officer could not disregard the valuation methodology adopted by taxpayer. However, the officer has the right to examine the underlying assumptions made for the purpose of the valuation of shares. As the start-up valuations are based on future cash flows, which are not generally backed by historical data, it becomes difficult to justify the assumptions with substantive documentation.

Based on representations made by the stakeholders, an exemption was provided to start-ups to encourage investment in and growth of start-ups, provided they satisfy certain conditions: the start-up must obtain a certificate of recognition from the DPIIT/DIPP; and the aggregate amount of post issue (including proposed issue) paid-up share capital and premium should not exceed ₹25 crore. This does not include investments by non-residents/venture capital companies or venture capital funds.

Additionally, such start-ups shall not be allowed to invest in certain specified assets for a particular duration — seven years from the end of the financial year in which the shares are issued at premium. Some of these assets include land, buildings, shares and securities.

The exemption shall be revoked with retrospective effect if the conditions are breached.

The conditions laid down for utilising the exemption are quite onerous and restrictive. For instance, a blanket restriction on investment in shares and securities impairs the ability of a start-up to expand its operations through acquisitions or setting up of subsidiaries. Therefore, though the exemption is a move in the right direction, the related conditions may have made it ineffective.

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Insulating India against global trade wars

Domestic manufacturing should be given a fillip by creating mega plug-and-play industrial parks through PPP mode

SUDHIR MEHTA

Global trade wars have been making headlines almost every day in recent times. Uncertainty is looming over both developed as well as emerging economies making economic survival and viability unpredictable.

In its quest to become a self-sufficient nation, promote domestic production and discourage imports, the government has been aggressively promoting the 'Make in India' initiative.

Being a self-sufficient nation is an ideal situation but requires active government intervention and support. The MSME sector, considered to be the engine of growth for any nation, is currently facing multiple challenges in India.

Absence of adequate and timely organised finance, limited knowledge, non-availability of suitable technology, high cost of credit and over-regulation are factors impeding growth of this sector.

Adding to the woes, currently, banks, NBFCs and other financial institutions are facing severe turbulence, thereby further choking the liquidity pipeline and growth engine of the nation.

The government should initiate a massive programme to support plug-and-play infrastructure for new manufacturing units similar to what is available for IT companies. India needs to create "mega industrial parks" in PPP (public-private partnership) mode, wherein all infrastructure should be under control of a single entity.

The parks should provide common facilities such as STP, ETP, transformer, UPS, packaging, general utility support, logistics management, and storage facilities.

In this scenario, prospective manufacturing units would only need to set up their plant and machinery without worrying about land acquisition and related challenges. Land acquisition is one of the major stumbling blocks for most multinational companies.

The plug-and-play infrastructure facility should disaggregate assets like land, building, common infrastructure, services and plant and machinery, while allowing easy transfer of machinery if the project is not viable.

Globally competitive rentals in the mega parks should be considered to encourage more participation.

Traditionally, land was considered a good investment option as it was expected to appreciate creating an asset for the future. In fact, many fortunes have been made on old industrial land converted for commercial use. Contrary to this, in the current scenario, land prices are high, stabilised and not expected to appreciate in the near future, thus being a discouragement for many companies and entrepreneurs.

Land acquisition is anyway considered to be a challenge that most would like to avoid. The IT industry, despite being cash-rich, has preferred to grow on a leasing rather than purchase model. A proposed plug-and-play infrastructure model is presented in the Table.

The government should start by identifying one cluster for import substitution and emerging export industry.

Within the cluster, at least 10 per cent of the space should be reserved for common services like banks, logistics, R&D labs, packaging, product displays, staff transportation, etc.

It should provide interest subvention of 5 per cent for all investments in these specified clusters and support developers to enable rent under viability gap funding model.

Will reduce costs

Data show that availability of plug-and-play facilities for manufacturing can have an overall reduction of around 28 per cent in project funding requirement as well as reduction in project gestation period by one year, having an impact of around 15 per cent reduction in finance cost.

The proposed model will help in reducing funding requirement, improve IRR for units, make it simpler for banks to assess project reports and help in easy closure or relocation of manufacturing units. The model will help in increasing employment for local communities by 2x-3x times as compared to standalone industrial units.

The plug-and-play model will have the flexibility of expansion and change as per business demand since there would be minimal constraints of land and building availability. A cluster approach will support the development of ancillary units as well as help reduce logistics costs and time-to-market.

A huge fillip to employment can be provided as each cluster has the potential to generate almost 200,000 new jobs. The cost of viability gap funding for the government will be more than recovered from the additional GST revenues and other taxes in the medium to long term.

Many construction jobs will also be created for the building of these mega industrial parks.

As compared to owned and mortgaged properties with legal issues, these assets would be easily transferable leading to reduction in NPAs (non-performing assets) and a 25-35 per cent reduction in capital requirement by SMEs.

To transform our nation from a trade deficit to a trade surplus one and insulate it from the growing global trade wars, the government needs to encourage growth in domestic manufacturing capacities. It should consider providing facilities like plug-and-play infrastructure that would help entrepreneurs, manufacturers and global companies set up manufacturing units in India.

"Make in India" is a strong initiative and needs to be supported not only by 'ease of doing business' or finance facilities, but should also be backed by easily available, hassle-free and value-for-money infrastructure.

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Industrial parks: A proposed model

Development scheme for import substitution	
10 clusters in different States of 2,000 acres each with focus on import substitution industries	20,000 acre
Development area (assuming built-up area of 40%)	348.48 million sq. ft.
Cost of land @ ₹1 crore per acre (assuming location nearby city)	₹20,000 cr
Investment in project building @ ₹1,200 per sq. ft.	₹41,820 cr
Total land and building investment (in phases)	**₹61,820 cr**
Possible number of industries	
Large enterprises: 60% area at 3,00,000 sq. ft. per unit	700
Medium enterprises: 20% area ar 50,000 sq. ft. per unit	1,400
Small and micro enterprises: 20% area at 20,000 sq. ft. per unit	3,500
Expected number of industrial units	**5,600**
Plant and machinery investment	**₹1,85,460 cr**
Investment generation	**₹2,47,280 cr**
Revenue generation (considering asset: turnover ratio 1:1.5)	**₹3,70,920 cr per annum**
GST to government @ 18%	**₹66,765 cr per annum**
Employment creation: Direct	**0.46 million (numbers)**
Employment creation: Indirect	**1.39 million (numbers)**
Total employment creation	**1.85 million (numbers)**

5 THINGS to WATCH OUT for TODAY

- **The YES** Bank board will meet to consider raising of funds through the issue of equity or equity-linked securities. However, the quantum of funds proposed to be raised has not been revealed.
- **Road Transport** Minister Nitin Gadkari will inaugurate the Canacona bypass. The 7.7 km bypass connecting Char Rasta in Canacona to Pollem, Goa, has three bridges and is located on National Highway 66. He will also inaugurate a grade separator in South Goa.

- **Students of** Jawaharlal Nehru University will hold a protest outside the HRD Ministry and demand that the recommendations of a committee, constituted to restore the smooth functioning of the varsity, be made public. The students' union protest is also to demand that the draft hostel manual, which has provisions for hostel fee hike, be completely rolled back.
- **The second** quarter GDP growth numbers are likely to be released. In the June quarter, the economy expanded 5 per cent, its slowest annual pace in six years. Analysts predict that the Q2 numbers may not be any better. The National Statistical Office will release the numbers.

- **Senior Congress** leader and former Uttarakhand Chief Minister Harish Rawat is likely to visit the makeshift Ram temple in Ayodhya. He will be the first political leader to do so after the Supreme Court ruling on the disputed site. He announced his visit plans on Twitter.

A THOUSAND WORDS

Keeping watch Horse-mounted policemen patrol the Maidan area, Kolkata, on a foggy Thursday morning. The Kolkata Mounted Police was introduced in 1840 to inform the harbour master whenever any ship was sighted and eventually to patrol the Maidan area KR DEEPAK

BusinessLine TWENTY YEARS AGO TODAY

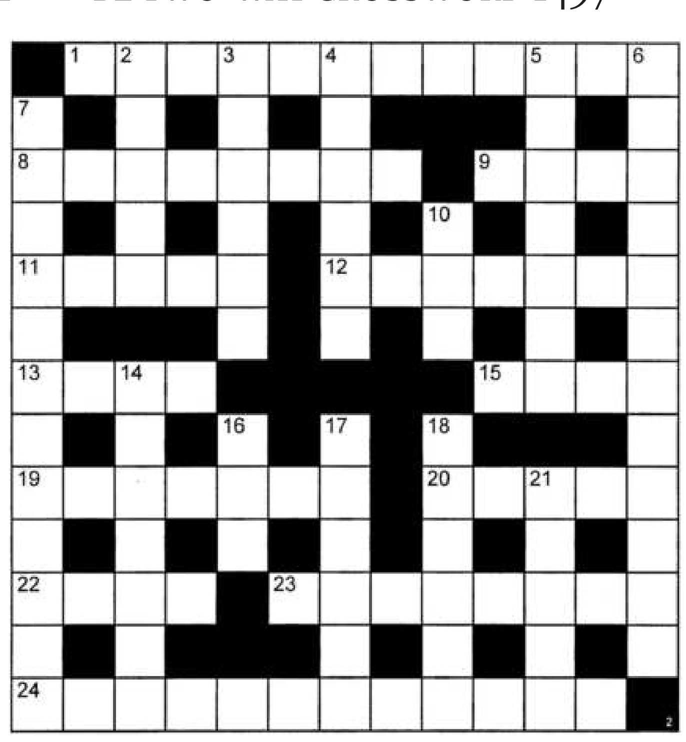
November 29, 1999

Finance Ministry to wield stick on tax defaulters
With pressure mounting to enhance direct tax collections, the Finance Ministry has decided to wield the stick on defaulting assessees. All tax recovery officers have been directed by the Centred Board of Direct Taxes (CBDT) to use coercive powers, including issuing warrants of arrests under civil procedure, sources said. The CBDT has convened an internal meeting where selection of cases for scrutiny, progress of scrutiny assessments and widening of the tax base under the one-by-six criteria would be reviewed.

Overseas acquisitions: Leeway for firms listed abroad
The Government is planning to provide more flexibility for acquisitions abroad by Indian firms only to those domestic companies listed overseas, especially on the US stock exchanges. The Finance Ministry has proposed this condition as it reckons that firms listed on the US stock exchanges have to adhere to stringent disclosure norms. Officials are of the view that considering that the US capital markets regulator, the Securities and Exchange Commission (SEC), has a tight rein on listed firms there, the potential for misusing this freedom could be slim

ONGC may be allotted more exploration blocks
Faced with the sharply growing oil import bill, the Petroleum Ministry appears inclined to allocate more oil exploration blocks to Oil and Natural Gas Corporation (ONGC), particularly in areas where it has taken up preliminary work. This could be done as an exception in cases where ONGC made an application for the blocks prior to February 11, the day when the Union Cabinet decided to allocate any new oil block only through international competitive bids, Ministry sources said.

BL TWO-WAY CROSSWORD 1497



EASY

ACROSS
01. Space to travel, see play, without seat (8-4)
08. Dreamy musical composition (8)
09. Look after; care (4)
11. Passage between seat rows (5)
12. One who doubts (7)
13. Military station (4)
15. Paradise garden (4)
19. Cradle-song (7)
20. Lozenge-shaped object (5)
22. Make, become bankrupt (4)
23. Old music ornament; lever in organ coupler (8)
24. Fast, non-stop rail service (7,5)

DOWN
02. Marks correct (5)
03. Sexless (6)
04. Produce electrically charged particles in (6)
05. Left out (7)
06. Heavy ball tossed and caught for exercise (8-4)
07. Too great to be reckoned (12)
10. Small in number (3)
14. Unadventurous, effeminate fellow (7)
16. Drinking-place; lever (3)
17. Way skirting town (6)
18. Dealer in shares, insurance etc (6)
21. African animal related to giraffe (5)

NOT SO EASY

ACROSS
01. A substitute horse-attendant where there's no seat to ride (8-4)
08. Piece of music will turn once it's composed (8)
09. Care about it being soundly seeded with explosives (4)
11. Church division a lie's disseminated about (5)
12. He doubts if it's putrefactive, having carbon in it (7)
13. Army depot roughly taken by army policeman (4)
15. Paradise garden will need to be dug over (4)
19. Soothing notes to bull lay scattered about (7)
20. Lozenge shape of a Greek letter to a degree, it's medical (5)
22. Won't go for a piece of portrait sculpture (4)
23. Coupler's lever leaves a wrestler supine (8)
24. It doesn't stop expert as sin is put right (7,5)

DOWN
02. Acarids one marks right (5)
03. The thing is, it's neither masculine nor feminine (6)
04. Charge particles to show one how one is to turn out (6)
05. Didn't put it in in order to do time, nothing being missing (7)
06. Punishment at a dance thrown for exercise (8-4)
07. It can't be reckoned how to calcine a bull (12)
10. Not many get iron at start of the week (3)
14. Silk mop used for him as he's so soft (7)
16. Don't let one into the snug (3)
17. Go around town, which perhaps pays in an empty bus (6)
18. An intermediary has no money to start reinvestment (6)
21. This animal is all right it's tailless ape one is after (5)

SOLUTION: BL Two-way Crossword 1496

ACROSS 01 Region 8. Order 9. Cowslip 11. Flattery 12. Jelly 15. Loft 16. Sty 17. Lake 19. Staff 21. Captious 24. Lashing 25. Virgo 26. Parody
DOWN 02. Elope 03. Insulate 04. Naif 05. Forte 06. Idle 07. Bray 10. Plentiful 12. Jolt 13. Fletcher 14. Self 18. Minor 20. Fined 21. Cave 22. Part 23. Samp