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Ministry of Commerce and Industry proposes relaxation of conditions for eligible start-ups to claim benefit of proviso to Section 56(2)(viib) of Income Tax Act 1961 (the Act)

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Background/ Facts

- As per the provisions of Section 56(2)(viib) of the Act, where a company in which the public is not substantially interested, receives any consideration for issue of shares exceeding the face value of shares, the aggregate consideration exceeding the fair market value of shares shall be taxable as an income under the head "Other Sources" in the hands of the recipient company.
- As per the proviso to Section 56(2)(viib) of the Act, the aforesaid provision shall not be applicable in a case where the consideration for issue of shares is received by a company from a class or classes of persons, as may be notified by the central government.
- In this regard, the Central Board of Direct taxes (CBDT) vide powers conferred under Section 56(2)(viib) of the Act, issued time to time notifications providing that Section 56(2)(viib) of the Act shall not be applicable in case of issue of shares of an 'eligible start-up' company, wherein an eligible start-up means
 - An entity (registered as Pvt Ltd Co./ LLP/ Partnership firm in India) shall be considered to be a start-up for up to a period of seven years from the date of incorporation/registration. (In the case of start-ups in the biotechnology sector, the period shall be up to ten years from the date of its incorporation/ registration).
 - Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded Rs. 25 crore.
 - 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.

Announcement by Union Minister of Commerce & Industry and Civil Aviation on February 19, 2019 with respect to exemption for start-ups under Section 56(2)(viib) of the Act

On February 19, 2019, the Hon'ble Minister announced that to provide relief to and boost investments into start-ups in India, the government has decided to widen the definition of 'start-up' and simplify the process of getting approval for exemption under Section 56(2)(viib) of the Act.

The key modifications as suggested by the Hon'ble Minister are as under:

- An eligible entity shall now be considered to be a start-up for up to **ten years** from the date of incorporation/ registration as against the existing duration of seven years.
- An entity will also be considered a start-up if its turnover for any of the financial years since its incorporation or registration does not exceed **Rs 100 crore** as against the existing limit of Rs 25 crore.
- Consideration received by eligible start-ups for shares issued or proposed to be issued by all investors shall be exempt up to an aggregate limit of Rs 25 crore.

- The aggregate limit of Rs. 25 crore will exclude consideration received by eligible start-ups for the following classes of persons:
 - Non-Residents
 - Alternative Investment Funds- Category-I registered with SEBI
 - Listed company having a net worth of Rs. 100 crore or turnover of at least Rs. 250 crore provided that its shares are frequently traded as per SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
- In addition, consideration received by eligible start-ups for shares issued or proposed to be issued to a listed company having a net worth of Rs. 100 crore or turnover of at least Rs. 250 crore will be exempted.

It is also understood that the parties will have to file for registration/approval with the DPIIT (successor to DIPP) which will in-turn forward the application to the CBDT which is the registering authority, to issue a formal registration/approval. It is expected that detailed operational modalities will be notified by the CBDT in due course. Based on the current Ministry of Commerce press note it appears that this relaxation covers active private limited companies (only) and accordingly, clarity is required on status of other recognized entities such as LLP etc. Similarly, the industry hopes that the CBDT will separately address the issue of applicability of Section 68 (unexplained investments) in such cases and also clarify whether the terms of this circular be applied retrospectively while considering appeals of ongoing cases.

Conclusion

The objective of this notification is to provide incentive/ boost to “start-ups” in India and ensuring availability of funds for start-ups and substantially addressing the concerns regarding the taxation of angel investments in this sector.

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