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The Chamber of Tax Consultants

THE CHAMBER'S JOURNAL

Your Monthly Companion on Tax & Allied Subjects

Vol. XI | No. 4 | January 2023

Start-up : Funding, Tax & Regulatory Aspects

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Indirect Taxes Committee

11th Residential Refresher Course on GST was held from 5th January, 2023 to 8th January, 2023 at Westin, Pune

Inaugural Session

Seen from L to R: CA Hemang Shah (Vice-Chairman), CA Ashit Shah, CA Atul Mehta (Imm. Past Chairman), CA Keval Shah (Convenor), CA A. R. Krishnan, CA Rajiv Luthia (Advisor), CA Sumit Jhunjhunwala (Chairman), CA Parag Ved (President), Mr. Rajesh Shukla (Chief Guest), CA Haresh Kenia (Vice-President), CA Raj Khona (Convenor), CA Yash Parmar (Convenor), CA Paresh P. Shah and CA Naresh Sheth

CA Parag Ved (President) giving his opening remarks.

Seen from L to R: CA Ashit Shah, CA Sumit Jhunjhunwala (Chairman), Mr. Rajesh Shukla (Chief Guest), CA Rajiv Luthia (Advisor) and CA Hemang Shah (Vice-Chairman)

CA Sumit Jhunjhunwala (Chairman) welcoming the delegates.

Seen from L to R: CA Ashit Shah, Mr. Rajesh Shukla (Chief Guest), CA Parag Ved (President), CA Rajiv Luthia (Advisor) and CA Hemang Shah (Vice-Chairman)

Chief Guest Mr. Rajesh Shukla (Senior General Manager, Indirect Taxation – Tata Motors Ltd.) giving key note address.

Seen from L to R: CA Ashit Shah, CA Sumit Jhunjhunwala (Chairman) CA Parag Ved (President), CA Rajiv Luthia (Advisor)

Panel Discussion

Panelist CA Jagdish Punjabi and CA Naresh Sheth replaying to the queries with Moderator CA Rajiv Luthia.

Seen from L to R: CA Jinit Shah, CA Pranav Kapadia and CA Shreyas Sangoi

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Editorial

Dear Readers,

While a new COVID variant, global economic crisis and several other challenges are confronting us, over the year 2023, the eternal HOPE for a better tomorrow is what is keeping this world going. During such uncertainties, one is reminded of one of the shloka from vedic scriptures, ***"Sarve Bhavantu Sukhinah, Sarve Santu Niarmaya"*** meaning "May all be happy, all be free from disease, be witness to all auspicious events and no one has to be a part of sorrow".

While globally there is lot of uncertainty and a perceptible slow-down in economic growth, India has emerged as the notable exception with a lot of positives. The estimates brought out by the Government indicate that growth is likely to be around 7% for 2022-23. It is worthwhile to mention here that while the established businesses are growing, the new generation of entrepreneurs is being encouraged by the Government to start their new ventures. Start Up India, an initiative of the Ministry of Commerce and Industry is one such step in the recognition of the talent of Gen Next..

India is a young country, with 65% of its population falling under the age bracket of 25 to 35 years. The rise of start-ups in India has happened slowly, over a gradual period particularly from 2008. The financial crisis that hit the world from 2008 forced businesses around the globe to reallocate their resources and lay off employees in large numbers. In India, it mostly affected the Information Technology professionals, who started looking for different business models to keep themselves afloat.

India boasts of more than 70,000 start-ups. About 50% of them are based in Tier II and Tier III cities, and their numbers are only rising. These start ups are in diverse fields such as e-commerce, fintech, biotech etc. Some time back India has achieved a significant mile stone of having 100 unicorns valued at ₹ 25 lakh crore.

The major factors that make India one of the world's most start up friendly nations are:

'(i) The cost of doing business is pretty low compared to other countries in the world. (ii) Both customers as well as vendors live in close proximity. (iii) 7 million graduates passing out every year, and many of them preferring to work in start ups. (iv) India has the second-largest internet user base after China, making it easier for companies to reach out to their local and distant audiences simply through Whatsapp and Facebook. (v) There are many venture funds, which are supporting and funding start ups. (vi) The Governments encourages and supports start ups

Till about the 90s, in India, the best talent of the nation was cornered up by big corporations only. However, with the of entrepreneurial bug biting more and more youngsters, these young talented individuals have found the journey of entrepreneurship more fulfilling in terms of exhibiting their unique talent..

The Prime Minister of India is a great supporter of start ups and according to him start ups are the back bone of the new India and has declared 16th January as "Start Up Day".

Start ups is an exciting area for professionals as well and our members need to be familiar with many issues. Considering that advice to start ups is one of the emerging practice areas for our members and also, to contribute in it's own way to the Start Up initiative, the Journal Committee has designed this issue. I would like to place my appreciation for the Journal Committee on record, for dealing with this important subject. My sincere gratitude to the authors for doing their bit for the nation by sharing their expert knowledge and sparing their valuable time to write the articles for this issue.

Taxation of start ups should have, in concept, been simple to be comprehensible to a non-finance person also, in line with the endeavour of the Government to encourage and nurture young talent. But, as it has been seen on numerous occasions, tax sometimes confuses all of us and entrepreneurs who are technologically equipped and not really aware of the world outside technology, struggle to grapple with the nuances thereof. It is therefore that the quote below, makes us ponder.

Life is really simple, but we insist on making it complicated.

— Confucius

Thought provoking, isn't it?

VIPUL K. CHOKSI
Editor

From the President

Dear Members,

At the outset, let me wish all the members a very happy and prosperous new year. The new year day is an occasion to celebrate, to plan for the coming year and to introspect the year gone by. I encourage you all to set ambitious goals and embrace new opportunities. Let's make 2023 a year of growth, prosperity and success for all of us.

The country's net tax collection has shown growth of 24% to ₹ 8.77 lakh crores in the April to November 22 of the ongoing fiscal and reached 61.79% of the full year budget estimates for financial year 2022-23. We have also seen GST collection at around 1.50 lakh crores per month from last couple of months. This steady growth in Direct and Indirect tax collection is the indicator of economic activity in the country.

The annual exercise of preparation and presentation of the budget by the Hon. Finance minister has already begun. Let's hope that forthcoming budget will help in India achieving its goal of becoming USD 5T economy.

The chamber has conducted NBFC Program which received very good response from members and had to stop the enrolment due to limitation of the capacity of the hall. I am happy to note the overwhelming response received for the 11th Residential Refresher Course on GST. The committee headed by Shri Sumit Jhunjhunwala is not leaving any stones unturned to make it a grand success. Our Direct Tax RRC at Indore is fully booked on Residential basis and few slots are available on NRRC basis. We are also in the process of finalising venue and other details of our International Tax RRC in June 2023.

All the professionals are now free from Scrutiny assessment and belated returns for assessment year 2022-23. Now is the time to Catch-up updating our knowledge

and educating ourselves. The chamber has lined up many programmes to welcome 2023. The first program is GST RRC at Pune in first week of January 2023. The International tax committee has organised study circles on various contemporary topics. We have program on Nuances of New Age Securities on 20th and 21st January. We will also be coming out with program on clause-by-clause analysis of Union budget. The details of the programs are published in the CTC News for your information.

This month special story is on "START UP - FUNDING, TAX & REGULATORY ASPECTS" The design of issue covers crucial and Important areas of Start-Up. The Journal committee deserves compliments for covering this very important topic and helping our readers to update themselves on the subject. I thank all the authors for their immense contribution towards their timely articles.

The magical Brazilian football star who rose from barefoot poverty to become one of the greatest and best-known athletes in modern history, died at the age of 82. Whether Pele was the greatest of all time or not is not material. He was the first, the original and the pioneer. The one who expanded the horizon of football and his nation and set the benchmark for everyone to follow. May his soul rest in peace.

Once again, Wishing you all a happy, healthy, and prosperous 2023.

PARAG S. VED
President

CA Umang Soni

Startup Recognition – Key Acknowledgment from Government

What sets apart a "Startup" from any other new businesses is that it offers either innovates new product or new service, which is not being delivered elsewhere or in the current region. The business either develops a new product/service or redevelops a current product/service into something better.

Startup India Scheme is an initiative by the Government of India for promoting entrepreneurship, innovation, Made-in-India, generation of employment and wealth creation. The goal of Startup India is the development and innovation of products and services and increasing the employment rate in India. Startup India was launched by Prime Minister Shri. Narendra Modi on 16th January 2016. The differentiating factors which is pertinent in any startup are –

1. working towards Innovation or development or improvement of products or services, or
2. working towards Innovation or development or improvement of processes, or
3. scalable business model with a high potential of employment generation, or
4. scalable business model with a high potential of wealth creation

The Benefits of Startup India Scheme is Simplification of Work, Finance support, Government tenders, Networking opportunities. Let's discuss them in details –

1. Financial Benefits

a. The startup incur a heavy cost for registering patents for unique goods and services. Under this scheme, the government provides 80% rebate on the patent costs. Moreover, the process of patent registration and related is faster for them. Also the Government shall bear the entire fees of the facilitators for any number of patents, trademarks or designs that a Startup may file, and the Startups shall bear the cost of only the statutory fees payable.

b. Huge Credit Guarantee Fund for startups through National Credit Guarantee Trust Company/SIDBI over 4 years.

c. A 'fund of funds' of INR 10,000 crores to support innovation driven Startups has been established which is being managed by SIDBI. The Fund of Funds for Startups (FFS) invests in SEBI registered Alternative Investment Funds (AIFs) which, in turn, will invest in Startups.

2. Income Tax Benefits

a. Tax Deductions - The Startups to get income tax exemption for 3 years in a block of 10 years, if they are incorporated between 1st April 2016 and 31st March 2023. To avail these profit-linked benefits one must get a Certificate of Eligibility from the Inter-Ministerial Board of DIPP.

b. Tax Exemption on Capital Gains - Section 54 EE has been introduced under the Finance Act, 2016 which provides for exemption of capital gain up to INR 50 lakhs arising out of transfer of long term capital asset invested in a fund notified by Central Government. Also, Section 54 GB of Income-Tax Act, 1961 has been amended to provide exemption from tax on capital gains arising out of sale of residential house or a residential plot of land if the amount of net consideration is invested in equity shares of eligible Startup for utilizing the same for purchase of specified asset.

c. Removal of Angel Tax - Tax exemption on investments above Fair Market Value (or angel tax) has been introduced for Startups. Revised norms for claiming angel tax exemption has been provided through a notification dated 11th April 2018.

3. Government Tenders

It is not easy to acquire the government tenders. Under this scheme, the startups get priority in getting government tenders. Also, they are not required to have any prior experience.

4. Lesser Compliances

The startups are allowed to self-certify compliance for 6 Labour Laws and 3 Environmental Laws through a simple online procedure.

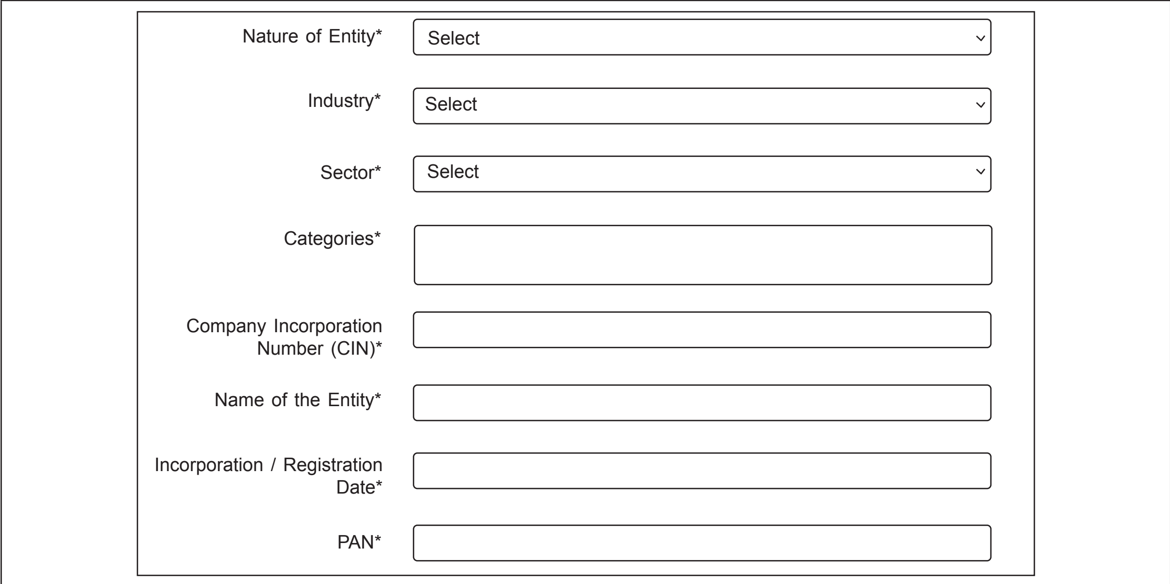
5. Huge Networking Opportunities

There have been many incubation centers and mentoring workshops where startups are empanelled through screening and get mentoring from stalwarts. Further there are many networking events which creates huge synergies and marketing opportunities. Startup India scheme also provides Intellectual Property awareness workshop and awareness.

In order to register an entity as startup with DPIIT, the incorporated entity has to be newly formed company or partnership firm or limited liability partnership. The eligible entity has to be not older than 10 years and should not have exceeded turnover of Rs. 100 crore in any of the previous years. Such eligible entity should not be formed by splitting or reconstruction of an existing business.

The recognition of startup under DPIIT involves registration of the business with StartupIndia website i.e. https://www.startupindia.gov.in/. Entire process of application for Startup Recognition is online with creating profile for startup business and filling up details shown in the below screenshots:

a. Entity Details:



Nature of Entity* Select

Industry* Select

Sector* Select

Categories*

Company Incorporation Number (CIN)*

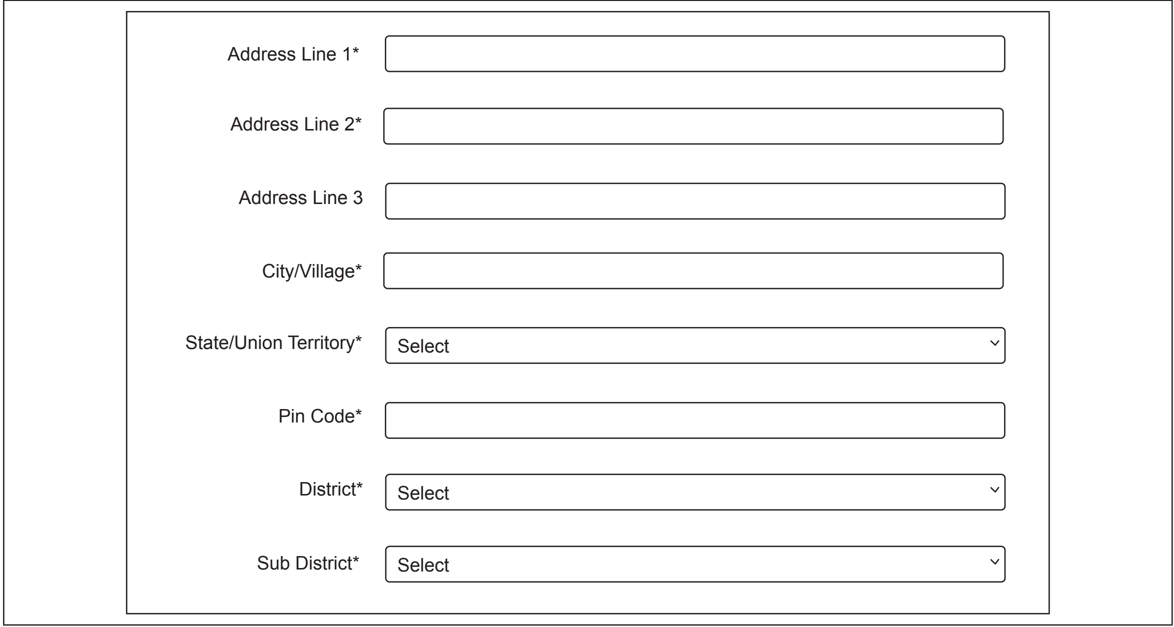
Name of the Entity*

Incorporation / Registration Date*

PAN*

Selecting Industry, Sector and Categories is important to classify the case apt with the officer.

b. Full Address (Office)



Address Line 1*

Address Line 2*

Address Line 3

City/Village*

State/Union Territory* Select

Pin Code*

District* Select

Sub District* Select

c. Authorised Representative Details

Name of Authorized Representative*

Designation of Authorized Representative*

Mobile No. of Authorized Representative*

Email ID of Authorized Representative*

All the communications for details sought, issuance of certificates, subsidies or programs available would be sent to email id of authorised representative. So, it's better to input the frequently accessed email id and preferred to have email id with company domain.

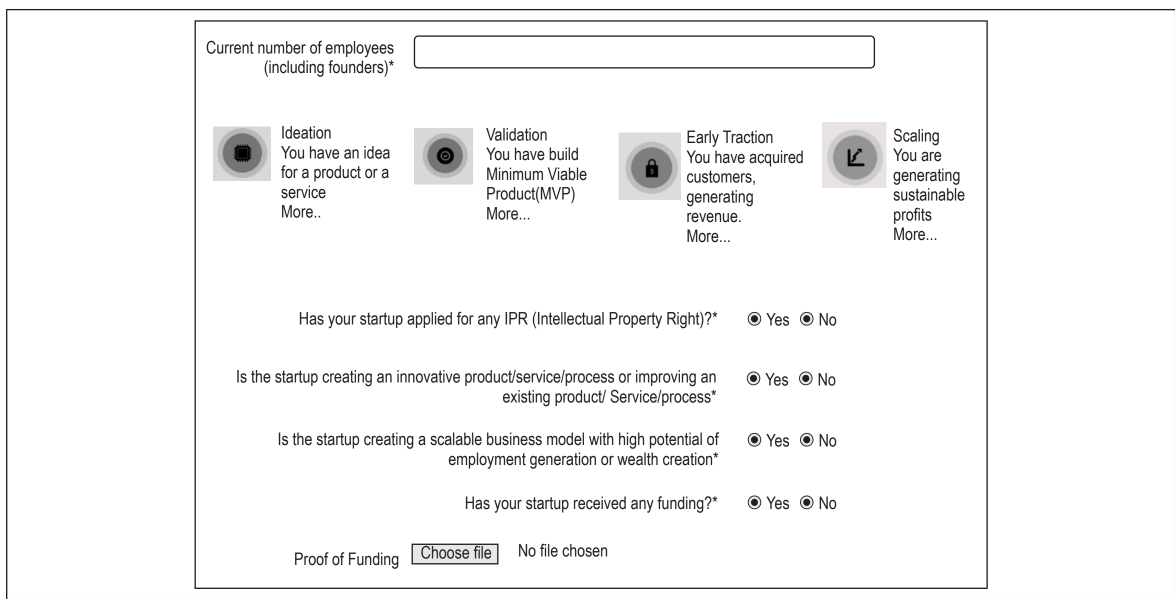
d. Director(s)/Partner(s) Details

Number of Director(s)/ Partners* Select

Directors Details*

S. No.	DIN/DPIN	Name of Director/Partner	Gender	Mobile Number	Postal Address	Email ID

e. Information Required



Current number of employees (including founders)*

Ideation
You have an idea for a product or a service
More..

Validation
You have build Minimum Viable Product(MVP)
More...

Early Traction
You have acquired customers, generating revenue.
More...

Scaling
You are generating sustainable profits
More...

Has your startup applied for any IPR (Intellectual Property Right)?* Yes No

Is the startup creating an innovative product/service/process or improving an existing product/ Service/process* Yes No

Is the startup creating a scalable business model with high potential of employment generation or wealth creation* Yes No

Has your startup received any funding?* Yes No

Proof of Funding Choose file No file chosen

The second and third question i.e. regarding product/service/process and regarding scalable business model needs to be properly articulated and explained in further reports and pitch deck which is attached to the application.

The requirement of funding received was important earlier, now the same has been waived off.

f. Startup Activities

Any awards/recognition received by the entity* ◉Yes ◉ No

Please mention any awards/recognition received by the entry

Upload Award Document [Choose File] No file chosen

What is the problem the startup is solving?*

How does your startup propose to solve this problem?*

What is the uniqueness of your solution?*

How does your startup generate revenue?*

The reply boxes have limitations of words and hence, it has to be crisp and in pointed forms. However the same should be detailed in the report and pitch deck with clear impact to the society at large and audience serving to. It does not matter that the same is being served by others. It matters that you may be serving different regions or audiences. Further what problem you solve is important to be represented meticulously as if it's being presented to investors. The report and pitch deck should have some market research data on market size, audience served, social and economic impact. Last but not the least, business should have revenue model through which it would generate returns and the same should not be mentioned with numbers, but with charging mechanism.

In case of Restaurant Franchise business like Subway, we can articulate the same as providing healthy diet food and also as gathering point for various business meetup, startup co-working space, etc. Further, it creates a large employment generation through online aggregators.

In another case of skin care product manufacturing; we can portray solution providers for 100% quality tested natural products, harmful chemical free products, effective against skin and hair problems as tested in labs, sustainable & personalized solutions which avoid skin irritation, side effects, etc.

Though above said product offerings may not be new or out of box, but the way it gets presented is the key for startup recognition. No doubt, each businesses creates a value in the society; however the same needs to be properly articulated.

g. Self-Certification

- I certify that the startup has not been incorporated for more than 10 years
- I certify that the turnover of the entity of any of the financial years since incorporation has not exceeded one hundred crore rupees
- I certify that the startup is working towards innovation, development or improvement of products or processes or services, or is a scalable business model with a high potential of employment generation or wealth creation; and
- I certify that the startup has not formed the entity by splitting up or reconstruction of a business already in existence;
- I certify that the entity is not formed due to compromise/ arrangement as provided under the Companies Act, 2013.
- I certify that the entity is neither incorporated/registered as a subsidiary of any Indian or foreign entity nor it is incorporated/registered as a holding company of any Indian or foreign entity. (Please note that any startup becoming holding/subsidiary of any company after obtaining recognition will be derecognized)
- I certify that the entity is not formed by Joint Venture. (Please note that any startup entering into any Joint Venture after obtaining recognition will be derecognized)
- I certify that the entity is not incorporated outside the Indian territory.
- I certify that the shareholding by Indian promoters in the startup is atleast 51%, as per Companies Act, 2013 and SEBI (ICDR) Regulations, 2018.
- I certify that the entity has not incorporated additional entities having similar address with same production line/ services and at least one common director/ designated partner/partner.
- I certify that the entity does not operate in domains specifically prohibited by law.
- I certify that the entity is not a sole proprietorship.
- I certify that the entity having common director/designated partner/ partner with any other entity fulfils the provisions of the Companies Act, 2013. I further certify that the entity shall not undertake any related party transaction with such common entities except transactions on arm's length basis.

Please select either of the below options applicable for the entity:*

- I certify that the entity is not the resultant entity or formed due to merger or demerger or acquisition or amalgamation or absorption.

  Or

- I certify that the entity is the result of merger or amalgamation under section 233 of the Companies Act, 2013 of two or more start-up companies; or one or more start-up company with one or more small company.

  (Please upload Recognition Certificates, NCLT order, form INC-28 and Financial Statement evidencing paid up capital and turnover as per the limits prescribed in the preceding FY in pdf, png, jpg with file size not exceeding 5 MB)

Please select the option/s mentioned below, if applicable, and provide supporting documents:

- I certify that the entity is formed as a result of conversion from one form to another subject to the fulfilment of condition provided in sub-section (3) of section 80-IAC of the Income-tax Act, 1961.

  (Please upload original incorporation Certificate and incorporation Certificate upon conversion in pdf, png, jpg with file size not exceeding 5 MB)

- I certify that the entity has changed its name as necessitated under the relevant provisions of the applicable Act and the entity is applying with the new name.

  (Please upload original incorporation Certificate and incorporation Certificate upon conversion for Private Limited and LLPs and original incorporation Certificate, Incorporation Certificate and Copy of the PAN card for Registered Partnerships in pdf, png, jpg with file size not exceeding 5 MB)

  - The entity/s CIN/LLPIN changed due to:
  - change in domicile State, or
  - due to conversion of entity from one form to another or
  - change in industry/ sector

  subject to approval obtained as per the relevant act.

  (Please upload original incorporation Certificate and incorporation Certificate upon conversion in CIN/ LLPN change in pdf, png, jpg with file size not exceeding 5 MB)

The documents which needs to be uploaded along with online applications are –

- Incorporation/Registration Certificate of your startup
- PAN Card
- Authorisation letter of the authorised representative of the company, LLP or partnership firm
- Proof of concept like pitch deck/website link/video (in case of a validation/early traction/scaling stage startup)
- Proof of funding, if any
- Patent and trademark details, if any
- List of awards or certificates of recognition, if any

The Project Report and Pitch Deck should have following components so as to meet reviewers' needs and avoid a situation where additional details are sought:

- About the Company with core offerings
- Vision, Mission, Target Audience
- Market Research, Market Size, Growth Capabilities of the Company

- Problems to be addressed – atleast 4-5 points with brief details
- Solutions to the Problems addressed – atleast 4-5 points with brief details
- Products/Services with photos
- Revenue Model with Projections
- Business till date/Stage of Startup with some key statistics
- Team – Name, Qualification and Experience
- Websites, Online Shopping Links, Social Media Handles, etc. – Website is important, even if it's with few pages on about the company, products, team and contact details. If social media handles are shared, try to have some posts about the company products and services or can have some blogging on relevant articles.

Lastly, would like to advise that half-hearted applications should not be submitted. It creates wrong image of the startup in the minds of reviewers. Further due to limitations on words and details filled in online application form, attached report and pitch deck should be utilized as a means of presenting the business offerings to officers as if they are potential investors. Very few cases are selected for online meeting for presentation by promoters, so the communication to such reports should be good enough for approval.

■●■

"Take up one idea. Make that one idea your life; dream of it; think of it; live on that idea. Let the brain, the body, muscles, nerves, every part of your body be full of that idea, and just leave every other idea alone. This is the way to success, and this is the way great spiritual giants are produced."

— *Swami Vivekananda*

"Power is of two kinds. One is obtained by the fear of punishment and the other by acts of love. Power based on love is a thousand times more effective and permanent than the one derived from fear of punishment."

— *Mahatma Gandhi*

"When learning is purposeful, creativity blossoms. When creativity blossoms, thinking emanates. When thinking emanates, knowledge is fully lit. When knowledge is lit, economy flourishes."

— *A. P. J. Abdul Kalam*

CA Chandrashekhar V. Chitale

Taxation aspects of Start-Ups

Role of Start-Ups in Economy

United Nations Organisation UNESCO observes that 'Achieving the Sustainable Development Goals (SDGs) will require the support of entrepreneurs, with start-ups having a key role to play. "Start-up Nations" and entrepreneurs came together this week at UNECE with the support of the Government of Israel to share their experiences in harnessing innovative entrepreneurship for sustainable development'.

India needs over one hundred million jobs annually and, most of the jobs are generated from startups and not from big enterprises. Startup entrepreneurship is important in today's generation as it brings innovation, new jobs and competitive dynamics to the business world and enterprises. In today's world, the role of startups in economic prosperity is increasing. Startup India is a Government of India flagship initiative to build Startups and nurture innovation. Through this initiative, the Government plans to empower Startup ventures to boost entrepreneurship, economic growth and employment across India. As of August 29, 2022, India had emerged as the world's third-largest startup ecosystem, with over 77,000 DPIIT-recognized startups spread throughout 656 districts. Hon. Prime Minister, Narendra Modiji observed "Our start-ups are changing the rules of the game. That's why I believe start-ups are going to be the backbone of new India."

Empirical Fiscal Research In India

A Survey by RBI confirms that Over the years, various instruments of fiscal policy *viz.*, taxation, public expenditure and public borrowings have been employed, with varying degrees of importance, to achieve higher economic growth and stability, efficient resource allocation and equitable distribution of income.

In this background, no wonder that tax lay affords certain incentives for players in Start-Up ecosystem. The present papers addresses these tax incentives.

Start-Up Ecosystem

The Start-Up Ecosystem, contextually covers three players viz:

(i) The Start-Up

(ii) Start-Up Entrepreneur and

(iii) Start-Up Investor

The Income-tax Act, 1961 prescribes law for ascertainment of income that is subjected to tax. These provisions are objective and provide for computation of income under five

heads of income and aggregation thereof for computation of taxable income.

However, considering importance of Start-Ups in growth of economy and achieving slated priorities, tax law has afforded certain concessions to these three categories involved in the ecosystem.

Tax Incentives for Start-Ups

While moving the Finance Bill, 2016, the Finance Minister in his speech stated that 'Startups generate employment, bring innovation and are expected to be key partners in Make in India programme. I propose to assist their propagation through 100% deduction of profits for 3 out of 5 years for startups set up during April 2016 to March 2019. MAT will apply in such cases. Capital gains will not be taxed if invested in regulated/notified Fund of Funds and by individuals in notified startups, in which they hold majority shares'.

Memorandum has explained that with a view to provide an impetus to start-ups and facilitate their growth in the initial phase of their business, a new section 80-IAC has been inserted in the Income-tax Act to provide a deduction of one hundred per cent of the profits and gains derived by an eligible start-up from a business involving innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property. The benefit of hundred per cent deduction of the profits derived from such business shall be available to an eligible start-up, being a company or Limited Liability Partnership (L.L.P), setup before 01.04.2019, subject of fulfilment of certain condition.

Thus, the Act provides for tax holiday for Start-Ups.

The Govt has announced 100% deduction under Section 80-IAC for eligible Start-ups from payment of Income Tax. Eligible start-ups formed on or after 1st April 2016 and before 1st April 2019 (later extended to 1st April 2023) can claim 100% Tax Exemption from payment of any Income Tax for any 3 consecutive years.

These three consecutive assessment years out of ten years beginning from the year in which the eligible start-up is incorporated for which 100% tax exemption is allowed can be chosen by the start-up at its own discretion (Amendment introduced *vide* Finance Act 2020).

Section 80-IAC provides benefit to (a) Eligible Start-Up that is (b) engaged in eligible business. Benefit provided in respect of such a Start Up is that, while computing the total income of the assessee, a deduction of an amount equal to one hundred per cent of the profits and gains derived from such business of an eligible start-up is allowed, for three consecutive assessment years. These three years should be consecutive ones, at the option of the assessee, out of ten years beginning from the year in which the eligible start-up is incorporated.

A start-up in order to be 'Eligible' for the deduction, the following three conditions are prescribed:

(i) It should be 'Eligible Start-Up';

(ii) it is not formed by splitting up, or the reconstruction, of a business already in existence; and

(iii) it is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

The first condition above i.e. (i) "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, 2023;

(b) the total turnover of its business does not exceed one hundred 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.

Condition (b) hereinabove shall be examined annually and for the year for which deduction is claimed. Thus, out of ten years, if deduction is claimed for year 4, 5 and 6, turnover should not exceed ₹ 100 cr. for these three years and the entitlement shall continue, even if it exceeds that limit for any one or more of the remaining seven years as we believe.

'Company' is defined under section 2(17) of the Act, as—

(i) any Indian company, or

(ii) any body corporate incorporated by or under the laws of a country outside India, or

(iii) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922) or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or

(iv) any institution, association, or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company:

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971 or on or after that date) as may be specified in the declaration;

Explanation (iii) to Section 80-IAC defines "limited liability partnership" as a partnership referred to in clause (n) of sub-section (1) of section 2 of the Limited Liability Partnership Act, 2008 (6 of 2009).

The second condition above i.e. (ii) deduction shall not apply in respect of a start-up which is formed as a result of the re-establishment, reconstruction or revival by the assessee of the business of any such undertaking as referred to in section 33B, in the circumstances and within the period specified in that section.

Undertaking as referred to in section 33B, means any industrial undertaking that carried on business in India is discontinued in any previous year by reason of extensive damage to, or destruction of, any building, machinery, plant or furniture owned by the assessee and used for the purposes of such business as a direct result of—

(i) flood, typhoon, hurricane, cyclone, earthquake or other convulsion of nature; or

(ii) riot or civil disturbance; or

(iii) accidental fire or explosion; or

(iv) action by an enemy or action taken in combating an enemy (whether with or without a declaration of war),

and, thereafter, at any time before the expiry of three years from the end of such previous year, the business is re-established, reconstructed or revived by the assessee.

The third condition above i.e. (iii) is that the Start-Up is not formed by the transfer to a new business of machinery or plant previously used for any purpose. There are two exceptions to this rule:

(1) any machinery or plant which was used outside India by any person other than the assessee shall not be regarded as machinery or plant previously used for any purpose, if all the following conditions are fulfilled, namely:—

(a) such machinery or plant was not, at any time previous to the date of the installation by the assessee, used in India;

(b) such machinery or plant is imported into India;

(c) no deduction on account of depreciation in respect of such machinery or plant has been allowed or is allowable under the provisions of this Act in computing the total income of any person for any period prior to the date of the installation of the machinery or plant by the assessee.

(2) Where in the case of a start-up, any machinery or plant or any part thereof previously used for any purpose is transferred to a new business and the total value of the machinery or plant or part so transferred does not exceed twenty per cent of the total value of the machinery or plant used in the business, then, for the purposes of condition (ii), the condition specified therein shall be deemed to have been complied with. For consideration of total value of the machinery or plant, any machinery or plant which was used outside India confirming to conditions mentioned in (1) above should be excluded.

“Eligible Business" has been defined under *Explanation (i)* of section 80-IAC to mean 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.

Department for Promotion of Industry and Internal Trade under Ministry of Commerce snd Industry has issued a Notification No. G.S.R. 127(E) dated 19th February, 2019 in supersession of the Gazette Notification No. G.S.R. 364(E) dated April 11, 2018 as modified *vide* Gazette Notification No. G.S.R. 34(E) dated January 16, 2019. It is provided that an entity shall be considered as a Start-up:

i. up to a period of ten years from the date of incorporation/registration, 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.

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

iii. 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'.

It may be noticed that the DIPP by way of notification dated February 19, 2019 has restricted the scope of 'eligible start-up' to mean and include only private limited companies and limited liability partnerships ('LLP'), and have thereby excluded public limited companies from the scope and ambit of 'eligible start-ups'. However, the Explanation (ii) to Section 80-IAC of the Act does not envisage any such exclusion and public companies can also be said eligible for deduction.

Paragraph 3 of the Notification is as follows:

Certification for the purposes of section 80-IAC of the Act

3. A Startup being a private limited company or limited liability partnership, which fulfils the conditions specified in sub-clause (i) and sub-clause (ii) of the Explanation to section 80-IAC of the Act, may, for obtaining a certificate for the purposes of section 80-IAC of the Act, make an application in Form-1 along with documents specified therein to the Board and the Board may, after calling for such documents or information and making such enquires, as it may deem fit, —

(i) grant the certificate referred to in sub-clause (c) of clause (ii) of the Explanation to section 80-IAC of the Act; or

(ii) reject the application by providing reasons.

Of course, section 80-IAC being a self-contained code for the purpose of deduction under that section, the other definitions, prescriptions, circulars, notifications, etc. shall not have bearing on determination of eligibility for deduction.

The other conditions stipulated for availing tax holiday by the eligible start-up are as under:

(a) Notwithstanding anything contained in any other provision of this Act, the profits and gains of an eligible business shall, for the purposes of determining the quantum of deduction for the assessment year immediately succeeding the initial assessment year or any subsequent assessment year, be computed as if such eligible business were the only source of income of the assessee during the previous year relevant to the initial assessment year and to every subsequent assessment year up to and including the assessment year for which the determination is to be made.

(b) The deduction from profits and gains derived from an undertaking shall not be admissible unless the accounts of the undertaking for the previous year relevant to the assessment year for which the deduction is claimed have been audited by an accountant, as defined in the Explanation below section 288(2), before the specified date referred to in section 44AB and the assessee furnishes by that date the report of such audit in the Form No. 10CCB (Rule 18BBB) duly signed and verified by such accountant.

(c) Where any goods or services held for the purposes of the eligible business are transferred to any other business carried on by the assessee, or where any goods or services held for the purposes of any other business carried on by the assessee are transferred to the eligible business and, in either case, the consideration, if any, for such transfer as recorded in the accounts of the eligible business does not correspond to the market value of such goods or services as on the date of the transfer, then, for the purposes of the deduction under this section, the profits and gains of such eligible business shall be computed as if the transfer, in either case, had been made at the market value of such goods or services as on that date:

Provided that where, in the opinion of the Assessing Officer, the computation of the profits and gains of the eligible business in the manner hereinbefore specified presents exceptional difficulties, the Assessing Officer may compute such profits and gains on such reasonable basis as he may deem fit.

For this purposes, "market value", in relation to any goods or services, means—

(i) the price that such goods or services would ordinarily fetch in the open market; or

(ii) the arm's length price as defined in clause (ii) of section 92F, where the transfer of such goods or services is a specified domestic transaction referred to in section 92BA.

(d) Where any amount of profits and gains of an undertaking or of an enterprise in the case of an assessee is claimed and allowed under section 80-IAC for any assessment year, deduction to the extent of such profits and gains shall not be allowed under any other provisions of this Chapter under the heading "*C.—Deductions in respect of certain incomes*", and shall in no case exceed the profits and gains of such eligible business of undertaking or enterprise, as the case may be.

(e) Where it appears to the Assessing Officer that, owing to the close connection between the assessee carrying on the eligible business to which this section applies and any other person, or for any other reason, the course of business between them is so arranged that the business transacted between them produces to the assessee more than the ordinary profits which might be expected to arise in such eligible business, the Assessing Officer shall, in computing the profits and gains of such eligible business for the purposes of the deduction under this section, take the amount of profits as may be reasonably deemed to have been derived therefrom:

Provided that in case the aforesaid arrangement involves a specified domestic transaction referred to in section 92BA, the amount of profits from such transaction shall be determined having regard to arm's length price as defined in clause (ii) of section 92F.

(f) The Central Government may, after making such inquiry as it may think fit, direct, by notification in the *Official Gazette,* that the exemption conferred by

> this section shall not apply to any class of industrial undertaking or enterprise with effect from such date as it may specify in the notification.

It is, also, worthwhile to note that the deduction is available for the undertaking and consequent ownership change of the undertaking does not necessarily impair the benefit of deduction.

Thus, there is benefit of three years tax holiday for eligible start up in eligible business.

Relaxation for Income from Other Sources

Section 56(2)(viib) provides that if unquoted shares are issued at a premium by a closely held company, the excess of premium over the fair market value of the shares shall be taxable as income from other sources in the hands of the company. However, where an eligible start-up fulfills the conditions prescribed in Notification No. GSR 127 (E) [F.NO.5 (4)/2018-SI], dated 19-2-2019, provisions of this section will not apply.

The Central Board of Direct Taxes Notification No. 13/2019 New Delhi, the 5th March, 2019 has provided that the Central Government, hereby notifies that the provisions of clause (viib) of sub-section (2) of section 56 of the said Act shall not apply to consideration received by a company for issue of shares that exceeds the face value of such shares, if the said consideration has been received from a person, being a resident, by a company which fulfills the conditions specified in para 4 of the notification number G.S.R. 127(E), dated the 19th February, 2019 issued by the Ministry of Commerce and Industry in the Department for Promotion of Industry and Internal Trade and published in the Gazette of India, Extraordinary, Part-II, section 3, Sub-Section (i) on 19th February, 2019 and files the declaration referred to in para 5 of the said notification of the Department for Promotion of Industry and Internal Trade.

Circular No. 16/2019 [F.No. 173/149/2019-ITA-I], dated 7-8-2019 *vide* paragraph 3 and 4 has clarified as follows:

3. In pursuance to the above, the Central Board of Direct Taxes (CBDT) had issued Notification No. 13/2019/F.No. 370142/5/2018-TPL(Pt.), dated 5th March, 2019 reiterating that the provisions of clause (viib) of sub-section (2) of section 56 of the said Act shall not apply to consideration received by a company for issue of shares that exceeds the face value of such shares, if the said consideration has been received from a person, being a resident, by a company which fulfils the conditions specified in para 4 of the notification dated 19.2.2019 issued by DPIIT. 4. In the light of the above, the following procedure is laid down with regard to the assessment of such startup entities involving the issue of section 56(2)(viib).

(i) Where the Startup Company has been recognised by the DPIIT but the case is selected under "limited scrutiny" on the single issue of applicability of section 56(2)(viib), no verification on such issues will be done by the AOs during the proceedings u/s 143(3)/147 of the I.T. Act, 1961 and the contention of such recognized Startup Companies on the issue will be summarily accepted.

(ii) Where the Startup Company has been recognized by the DPIIT but the case is selected under "limited scrutiny" with multiple issues or

under "complete scrutiny" including the issue u/s 56(2)(viib), the issue of applicability of section 56(2)(viib) will not be pursued during the assessment proceedings and inquiry or verification with regard to other issues in such cases shall be carried out by the Assessing Officer, only after obtaining approval of his/her supervisory officer. Due procedure as per I.T. Act shall be followed with regard to other issues for which the case has been selected.

(iii) Where the Startup Company has not got DPIIT approval and the case is selected for scrutiny, inter alia on the grounds of applicability of section 56(2)(viib) or any other issue/s, then also inquiry or verification in such cases shall be carried out by the Assessing Officer, as per due procedure, only after obtaining approval of his/her supervisory officer.

An Unstarred Question No. 759[1]. answered on Wednesday, the 26th June, 2019 by the Minister of Commerce & Industry Shri Piyush Goyal also confirmed this position. The Minister said Startups receiving investments from Ventures Capital Fund are exempt from taxation as per provision of Section 56(2)(viib) of Income Tax Act, 1961 (Act). Angel Fund is subcategory of Ventures Capital Fund under Category-I Alternative Investment Fund (AIF), hence, eligible for the same exemption.

Set-off and Carry Forward of Losses

In the case of a closely held company, Section 79 imposes certain conditions for set-off the carried forward losses. Where substantial change has happened in the voting power of a company, the carried forward losses cannot be set off by such a company.

However, in the case of an eligible start-up, such losses can be carried forward on the satisfaction of any of the two conditions specified below:

(1) Continued 51% shareholding

In the year of set-off of losses, at least 51% of voting power is beneficially held by the same persons who held them as on the last day of the year in which loss was incurred; or

(2) Continued 100% shareholders with the same voting rights

100% of shareholders, on the last day of the previous year in which loss was incurred, continue to hold the same shares on the last day of the previous year in which loss is to be set-off. Further, such losses should have been incurred during seven years beginning from the year of incorporation of the company.

Tax Withholding Deferment

Section 192 of the Act requires any person responsible for paying any income chargeable under the head "Salaries" shall, at the time of payment, deduct income-tax on the amount

1. https://dpiit.gov.in/sites/default/files/lu_759.pdf

payable at the average rate of income-tax computed on the basis of the rates in force for the financial year in which the payment is made, on the estimated income of the assessee under this head for that financial year. Salary should be computed as provided in law.

However, a concession has been made in case of an employer, being an eligible start up referred to in section 80-IAC in the form of deferment of payment of tax on ESOPs.

For the purposes of deducting or paying tax under section 192, an eligible start-up as above, paying any income to the assessee being perquisite of the nature specified in section 17(2)(vi) in any previous year relevant to the assessment year, beginning on or after the 1st day of April, 2021, shall deduct or pay, as the case may be, tax on such income within fourteen days —

(i) after the expiry of forty-eight months from the end of the relevant assessment year; or

(ii) from the date of the sale of such specified security or sweat equity share by the assessee; or

(iii) from the date of the assessee ceasing to be the employee of the person,

whichever is the earliest, on the basis of rates in force for the financial year in which the said specified security or sweat equity share is allotted or transferred.

Concessional Tax Rate

"We today propose to slash the corporate tax rates for domestic companies and for new domestic manufacturing companies," the finance minister said at the meeting.

Nirmala Sitharaman said the revenue foregone on reduction in corporate tax and other relief measures will be ₹ 1.45 lakh crore annually. Prime Minister Narendra Modi has hailed his government's decision to slash corporate tax rates. "The step to cut corporate tax is historic. It will give a great stimulus to Make in India, attract private investment from across the globe, improve competitiveness of our private sector, create more jobs and result in a win-win for 130 crore Indians," he tweeted.

The Government enacted the Taxation Laws (Amendment) Ordinance 2019 to make certain amendments in the Income-tax Act 1961 and the Finance (No. 2) Act 2019. The salient features of these amendments are as under:-

a. **Section 115BAA:** In order to promote growth and investment, a new provision has been inserted in the Income-tax Act. From FY 2019-20 a domestic company has an option to pay income-tax at the rate of 22% subject to condition that they will not avail certain exemptions/incentives. The effective tax rate for companies opting this regime, shall be 25.17% inclusive of surcharge and cess.

b. **Section 115BAB:** To attract fresh investment in manufacturing sector and thereby provide boost to 'Make-in-India' initiative of the Government, another provision has been inserted in the Income-tax Act from FY 2019-20. A new domestic company incorporated on or after 1st October, 2019 making fresh investment in manufacturing, an option is available to pay income-tax at the rate of 15%. This benefit is available to companies which do not avail certain exemptions/incentives and commences production on or before 31st March, 2024. The effective tax rate for these companies shall be 17.16% inclusive of surcharge and cess.

For both these concessions:

1. The total income of the company shall be computed *inter alia*,

   (i) without any deduction under the provisions of section 10AA or section 32(1)(iia) or section 32AD or section 33AB or section 33ABA or sub-clause (ii) or sub-clause (iia) or sub-clause (iii) of sub-section (1) or sub-section (2AA) or sub-section (2AB) of section 35 or section 35AD or section 35CCC or section 35CCD or under any provisions of Chapter VI-A other than the provisions of section 80JJAA or section 80M;

   (ii) without set-off of any loss carried forward or depreciation from any earlier assessment year, if such loss or depreciation is attributable to any of the deductions referred to in clause (i);

   (iii) without set-off of any loss or allowance for unabsorbed depreciation deemed so under section 72A, if such loss or depreciation is attributable to any of the deductions referred to in clause (i); and

   (iv) by claiming the depreciation, if any, under any provision of section 32, except sub-section (1)(iia) of the said section, determined in such manner as may be prescribed.

2. Moreover, such companies shall not be required to pay Minimum Alternate Tax.

   Start Up companies can opt for the concessional tax regime, where tax holiday is not available.

Capital Gains Exemption

Capital gains from transfer of any capital asset attracts capital gains tax.

Section 54GB of the Act allows exemption on capital gains arising from transfer of residential property being a house or a plot of land owned by an Individual or HUF subject to compliance of certain conditions *viz*:

(i) Net consideration arising out of such transfer is utilised for subscription in the equity shares of an eligible start-up fulfilling prescribed conditions; and

(ii) Such eligible start-up has utilised this amount for purchase of new asset within one year from the date of subscription in equity shares by assessee.

For subsequent transfer of equity or new asset, provision for withdrawal of tax concession are also made.

The provisions of this section 54GB for an investment in equity of eligible start-up, do not apply to any transfer of residential property made after the 31st day of March, 2022.

Sum Up

The Indian startup ecosystem did exceptionally well in last couple of years - the growing investor confidence in Indian startups is overwhelming and is seen gaining momentum across different stages of growth in a startup journey, including seed-stage funding. Tax policy is also contributing to develop this ecosystem. The paper orients stakeholders about the tax concessions and other provisions applicable to start ups.

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CA Prity Dharod

Taxation aspects for Start up Promoter

"Chase the vision, not the money; the money will end up following you."

Tony Hsieh, Zappos CEO

The fundamental aim of every investor is to earn high returns and maximize profits. A well-planned and ideal business exit strategy can help in maximizing profits and returns. In the case of startup investors, once the required investment value is achieved, which is usually in a 5-to-7-year range, they plan to exit the companies by transferring their share of equity holdings. The resulting profit from the transfer of shares is taxed as capital gains – Long term or Short term depending upon the period for which the shares are held. Usually, such gains should not be taxed as business income.

Identifying the asset as a Long term or Short term is very crucial as the treatment is different for both under the Income Tax Act, 1961 ('the Act') – be it losses or gains. S. 2(42A) of the Act defines a short-term capital asset. In the case of unlisted shares of a company, the asset is said to be short-term if it is held for 24 months or less and long-term if held for more than 24 months. In a transaction of sale or purchase of unlisted shares, S. 50CA and S. 56(2)(x) of the Act get triggered off. As per Section 50CA, in the case of unquoted shares, where the consideration received is lower than the fair market value (FMV) as determined in terms of Rule 11UAA, then to compute capital gains u/s. 48 of the Act, the FMV shall be taken as the full value of the consideration received as a result of the transfer. As per S. 56(2)(x), in the case of unquoted shares, where a person receives any shares either without consideration or for a consideration which is less than the aggregate fair market value of the shares by an amount exceeding fifty thousand rupees, then the such difference shall be treated as income in the hands of the receiver of shares. The fair market value is to be computed in terms of Rule 11U and 11UA or as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares of its assets, whichever is higher.

The rates of income tax in case of Short term capital gains shall be the applicable slab rate. If the exit is by way of the buyback of shares by the company, then the company is liable to pay tax at the rate of 20% u/s. 115QA and the same becomes tax-free in the hands of the shareholder. In the case of Long term capital gains, the applicable rate is 20%. These income-tax rates are further subject to a surcharge and education cess. The maximum applicable surcharge rate is 37%. To give a

boost to the startup community, the Finance Act 2022 has set a cap on the surcharge rate to 15% on all long-term capital gains arising on the sale of any type of asset. Earlier, this limit of 15% on surcharge was applicable only to the sale of listed securities which were covered u/s. 112A of the Act.

Start-up entities can choose the form any type of entity which suits them. Taxability of the investors' gains would be dependent on the nature of instruments through which he has invested depending upon the nature and form of entity. A start-up entity can be a proprietorship firm, partnership firm, Limited Liability partnership, or Company.

The taxation laws have brought in many benefits for startups under the Income-tax Act, depending upon the form of a startup entity. The DPIIT (Department for promotion of Industry and Internal Trade) recognizes only the following form of entities for the registration as a 'Startup entity' (i) Registered Partnership Form (ii) Limited Liability Partnership (LLP) or (iii) a Private Limited Company. Further Income-tax does not provide benefits to all types of entities. Any structure which doesn't have a tax advantage may lead to reduced gains for investors. The eligibility for the income tax benefits for the various forms of entities is tabulated below:

Tax benefits	Registered Partnership Firm	Limited Liability Partnership	Private Company
Tax Holiday u/s. 80 IAC (if it is incorporated on or after 1st April, 2016 but before the 1st day of April, 2023)	Not Available	Available	Available
Benefit u/s. 54GB	Not Available	Not Available	Available
Income u/s. 56(2)(viib) – Angel tax	Not Applicable	Not Applicable	Available
1st proviso to S. 68 (2nd proviso from A.Y. 2023-24)	Not Applicable	Not Applicable	Available
Carry Forward of losses u/s. 79	Not Applicable	Not Applicable	Available

Rollover Benefit of s. 54GB of The Income Tax Act, 1961

Section 54GB of the Income Tax Act provides for exemption on Long Term capital gains arising to an individual or HUF from the sale of a residential property, a house or a plot of land if the proceeds are invested in equity shares of an eligible company. The limitation is that this section 54GB will not apply to any transfer of residential property made after the 31st March 2022.

Exemption Available

Amount of Net sales consideration		Amount of exemption available
(i)	Is greater than the cost of the new asset purchased	Cost of new asset x (Capital gains/Net Consideration
(ii)	Is less than or equal to the cost of the new asset purchased	Entire capital gains

Key features of this section are as follows:

- Available only to an individual or a Hindu Undivided Family (HUF)
- The capital gain should have aroused from the transfer of a long-term capital asset, being a residential property
- The net consideration to be utilised for subscription in the equity shares of an eligible company (hereinafter 'the company)
- The option has to be exercised before the due date of furnishing of return of income under sub-section (1) of section 139
- The company has utilised this amount for the purchase of a "new asset" before the due date of furnishing the return of income by the assessee under section 139 or the amount shall be deposited by the company before the said due date in a Capital Gain Deposit Account scheme to be utilised for the purchase of the new asset before the completion of one year from the date of subscription in equity shares by the individual or HUF
- The amount which the company has already utilised for the purchase of the new asset together with the amount deposited in the Capital Gain Deposit Account scheme shall be deemed to be the cost of the new asset
- If the amount deposited in the Capital Gain Deposit Account scheme is not utilized, either partly or fully, for the purchase of the eligible capital asset, then the exemption u/s 54GB as claimed by the assessee in the earlier assessment year will be revoked to the extent of the non-utilization of the funds deposited in Capital Gains Account Scheme as it bears to the total value of the Net Consideration.
- The equity shares or the eligible asset acquired by the company should not be sold within 5 years from the date of acquisition of shares/capital asset (3 years in case of computer or computer software)
- If the conditions are violated, the amount chargeable as LTCG in the hands of the assessee in the year of violation shall be calculated as under:

(Amount claimed as exemption u/s 54GB in earlier assessment year) – (Total Capital Gain x Total amount invested in new asset till expiry period/Amount of Net Consideration)

"New asset" means new plant and machinery but does not include—

(i) any machinery or plant which, was earlier used by any other person – within or outside India

(ii) any machinery or plant installed in any office premises or any residential accommodation or a guest house;

(i) any office appliances

(ii) Computers or computer software; other than a technology-driven start-up certified by the Inter-Ministerial Board of Certification notified by the Central Government in the Official Gazette

(iv) any vehicle; or

(v) any machinery or plant, the whole of the actual cost of which is allowed as a deduction (whether by way of depreciation or otherwise) in computing the income chargeable under the head "Profits and gains of business or profession" of any previous year

"Eligible company" means

(i) A Company incorporated in India

(ii) The date of incorporation of the Company should not be before the 1st day of April of the Financial Year in which the capital gain arises and not later than the due date of furnishing return of income u/s 139(1)

(iii) The company should be engaged in the production of an article or a thing or an eligible business

(iv) Post subscription of the shares, the individual or HUF should hold more than 25% of the share capital of the Company or should be entitled to more than 25% of the voting rights in the company.

(v) The company should qualify as a Small/Medium under the Micro, Small and Medium Enterprises Act, 2006 or is an eligible start-up;

(vi) "eligible start-up" and "eligible business" shall have the meanings respectively assigned to them in the *Explanation* below sub-section (4) of section 80-IAC

Consequences on the transfer of equity shares/capital assets acquired before the completion of a period of 5 years:

Situation	Taxability of individual/HUF arising in the year of transfer	Taxability of the company
Equity shares are transferred	- Exemption claimed in the earlier year shall be deemed income - Capital Gains on the sale of shares shall also be taxed	No liability
Asset is transferred	Exemption claimed in the earlier year shall be deemed income	Capital Gains on the transfer of assets shall be taxed

There could be issues as to whether the exemption is not available or would be lost in under mentioned circumstances-

- Is it necessary that shares should be subscribed at par or even shares can be subscribed at a premium? Value at which shares to issue i.e. whether at or at a premium as such should not make any difference in claiming the exemption provided other conditions are fulfilled. However, care is to be taken that shares are issued based upon proper valuation reports as required under Income-tax Act, Companies Act and other applicable regulatory laws.
- Where investment can be made in the instrument which can be compulsorily convertible into equity in future? The section specifically refers to the investment in equity shares. One may still argue that even though investment is made in the compulsorily convertible instrument into equity, there is no

option for non-conversion and hence exemption should not be lost. However considering the language of the section, in the case of the investment into the compulsorily convertible instrument exemption may not be available.

- What if some of the eligible assets were required to be disposed of due to business requirements or assets have become redundant within 5 years? In the fast changing technological environment, assets becoming obsolete quickly could not be ruled out. Assets become useless even due to natural calamities. In absence of the saving provisions exemption claimed in past may be lost in future. The law does not contemplate or require the performance of an impossible act - Lex non cogit ad impossibilia. Requiring the investor assessee to maintain that the investee company continues to hold eligible assets for a specified period may be impossible for the investor assessee. This condition is harsh since the fate of the investor's exemption is based on the action of the investee company.

- What if some/few shares have been disposed of by the investor within 5 years? One of the conditions is to hold the allotted equity shares for 5 years. Even partial exit may lead to loss of exemption.

- What if in case the company has undergone restructuring or is taken over by another company and the investor is allotted shares in the new company instead of old shares? In the case of tax compliant merger, equity shares are not disposed off. Investors would be receiving new shares instead of existing equity shares. Given this investors should not lose the exemption.

Changes Brought in by 1st Circular of The New Year 2023

- The CBDT has vide circular no. 01 of 2023 dt. 6th January 2023 has gifted tax relief to the taxpayers by providing a further extension of timelines to comply with provisions of section 54 to 54GB. Because of the then-prevailing COVID-19 pandemic and resultant restrictions imposed, the CBDT has said that the compliances to be made by the taxpayers such as investment, deposit, payment, acquisition, purchase, construction or such other action, by whatever name called to claim an exemption under Section 54 to 54GB of the Income Tax Act 1961 for which the last date of such compliance falls between 01-04-2021 to 28-02-2022 (both days inclusive), such compliance may be completed on or before 31-03-2023. Earlier said relaxation was provided for compliances which fell between 01-04-2021 to 29-09-2021(both days inclusive) to be completed on or before 30-09-2021.

- Need to ponder upon how this notional New Year gift is to be availed by the taxpayers. The circular has been issued by CBDT after the due date for filing the belated or revised return for AY 2022-23 which was 31st December 2022 has already passed. In case of a person who could not invest, deposit etc. by 30th September 2021, would have already offered the income to tax in the return of income for Assessment Year 2022-23. Now even if someone makes an investment up to 31st March 2023, how one can take advantage? Whether taxpayer after making an eligible investment can file for rectification u/s 154? Given the filing is to be made on efiling portal there is limited flexibility for the taxpayers.

Section 56(2)(viib) – ANGEL TAX

Section 56(2)(viib) deals with taxing the consideration received in the form of a share premium more than the Fair Market Value of the shares in the hands of the company issuing the shares(i.e. start-ups in the instant case).

Ingredients for applicability of Angel Tax

- A person is a Private limited company (PLC)
- PLC has received consideration for the issue of share
- Consideration has been received from a resident person
- Consideration received exceeds the face value of the shares i.e. shares have been issued at a premium
- Consideration received exceeds the fair market value of the shares

If the above conditions are satisfied, then such excess of the consideration received which exceeds the fair market value shall be considered as an income in the hands of the company. For this clause, the fair market value of the shares shall be the value (i) as may be determined in accordance with such method as may be prescribed (Rules 11U and 11UA); or (ii) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, or its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher.

The benefit to Startups: The 1st proviso to S. 56(2)(viib) provides an exemption from receipt of such consideration for the issue of shares when it has been received by a venture capital undertaking from a venture capital company or a venture capital fund or by a company from a class or classes of persons as may be notified by the Central Government in this behalf. Notification no S.O. 1131(E) dt. 5-3-2019 (to be applied retrospectively w.e.f. 19-2-2019) provides an exemption to start-ups subject to the fulfilment of conditions in para 4 and para 5 of the DPIIT Notification No. GSR 127(E) dt. 19-2-2019

2nd proviso to the S. 56(2)(viib) provides that in case of failure to comply with the conditions, then, any consideration received for the issue of a share that exceeds the fair market value of the such share shall be deemed to be the income of that company chargeable to income-tax for the previous year in which such failure has taken place and, it shall also be deemed that the company has under-reported the said income in consequence of the misreporting referred to in subsection (8) and sub-section (9) of section 270A for the said previous year (applicable from 1st April 2020)

Relaxation from 1st Proviso to Section 68 (2nd Proviso from A.y. 2023-24)

Start-up companies have also been excluded from the harrowing provisions of S. 68 of the Income Tax Act. [provided the money is received from a venture capital company or a venture capital fund as referred to in clause (23FB) of section 10]

As per S. 68 of the Act, where any sum is found credited in the books of an assessee for which there is no explanation about the nature and source thereof or the explanation offered by the assessee is not, satisfactory to the Assessing Officer, then the sum so credited is charged to income-tax as the income of the assessee of that previous year. In the case of a closely held Company, where the credit amounts consist of share application money, share capital, share

premium or any such amount, then the explanation offered by the company shall not be treated as satisfactory unless, in the case of a resident, the person in whose name such credit is recorded in the books of the such company also explains the nature and source of such sum so credited; and such explanation is found to be satisfactory in the opinion of the Assessing Officer.

Carry Forward of Losses – Section 79

Indian Income Tax laws contain provisions to carry forward and set-off the losses incurred in a financial year against the income of the subsequent financial years. These provisions are crucial for a startup as it incurs losses in the initial years of operations. Allowing carry forward and set-off of losses reduces the taxation burden on a start-up in the initial years of profits and results in a positive impact on its cash flows. However, a startup may not be able to carry forward and set-off the losses if section 79 of the Act is triggered, which restricts the carry forward and set-off of losses by a closely held company in certain cases of change in shareholding.

Section 79 of the Income-tax Act provides conditions for carrying forward and set off of losses in case of a company not being a company in which the public are substantially interested.

Prior to the amendment done by Finance (No. 2) Act 2019, clause (a) of this section applied to all such companies, except an eligible start-up as referred to in section 80-IAC, while clause (b) applied only to such eligible start-up. Under clause (a), no loss incurred in any year prior to the previous year was to be carried forward and set off against the income of the previous year, unless, on the last day of the previous year, the shares of the company carrying not less than fifty-one per cent of the voting power were beneficially held by persons who beneficially held shares of the company carrying not less than fifty-one per cent of the voting power on the last day of the year or years in which the loss was incurred. Under clause (b), the loss incurred in any year prior to the previous year shall be carried forward and set off against the income of the previous year, if, all the shareholders of such company who held shares carrying voting power on the last day of the year or years in which the loss was incurred, continued to hold those shares on the last day of the such previous year and such loss has been incurred during seven years beginning from the year in which such company is incorporated.

This condition of continuing to hold all shares, applicable to the initial promoters as well as all persons investing subsequently in the start-up, was creating practical hardship to the shareholders to exit since PE investors generally look at the time frame of 3 to 5 years for the exit at a higher price and any such exit would trigger section 79 limitation for the startup company.

The Government, in pursuance of the start-up action plan and facilitating ease of doing business, introduced a beneficial regime for a start-up to carry forward and set off losses. Section 79 was amended to provide that loss incurred in any year prior to the previous year, in the case of a closely held eligible start-up, shall be allowed to be carried forward and set off against the income of the previous year on the satisfaction of either of the two conditions stipulated at clause (a) or clause (b). This has brought greater flexibility for the investors to exit whenever they wanted. However, no such advantage is available if the such start-up is a partnership firm or LLP.

Deferment of TDS Deduction and Tax Paymentin Case of ESOP of Startup

Employee Stock Option Plans (ESOPs) have been used significantly as an incentive to hire and retain talent by start-ups as it allows

the newly formed company to employ highly talented employees without much affecting their cash flow as part of the employee's salary is being paid by way of ESOPs. ESOPs also make the employee part-owner of the Startup. Thus, the emotional connection to the Startup is much higher vis-à-vis full cash compensation. ESOP's are taxed as perquisites u/s. 17(2)(vi) of the Income Tax Act 1961 at the time of exercising the option by the employee and again at the time of sale, they are taxed as capital gains. Thus, the taxation of ESOP's happens at two stages in different time periods. Since ESOP is compensation received by the employees in kind, it can be a reason for a cash crunch, for the company for payment of TDS as the tax on the ESOP prerequisite has to be paid at the time of exercising the option and for the employee, who has to pay tax on notional income.

In order to ease the burden of payment of taxes by the employees of the eligible start-ups or TDS by the start-up employer, section 192 of the Act, was amended by inserting sub-section (1C) therein to clarify that to deduct or pay tax under sub-sections (1) or (1A) thereof, as the case may be, a person, being an eligible start-up referred to in section 80-IAC, responsible for paying any income to the assessee being perquisite of the nature specified in clause (vi) of sub-section (2) of section 17 of the Act, in any previous year relevant to the assessment year 2021-22 or subsequent assessment year, deduct or pay, as the case may be, tax on such income within fourteen days —

(i) after the expiry of forty-eight months from the end of the relevant assessment year; or

(ii) from the date of the sale of such specified security or sweat equity share by the assessee; or

(iii) from the date on which the assessee ceases to be the employee of the person;

whichever is the earliest on the basis of rates in force of the financial year in which the said specified security or sweat equity share is allotted or transferred. Similar amendments have been carried out in section 191 (for the assessee to pay the tax direct in case of no TDS) and in section 156 (for notice of demand) and in section 140A (for calculating self-assessment).

Deferral of tax on ESOP ends at the earliest of the occurrence of the three specified events and is not affected even if the company is no longer an eligible start-up at any later date after the issue of ESOP.

Epilogue

Currently, the startup ecosystem in India is in an exciting phase. As such start-ups get themselves distinguished for the existing business. It's how it operates that is most the distinguished start-up feature. Start-ups may at times take higher risks. Hence start-ups need to be dealt with differently. This necessitates having special provisions. However, the tax environment needs to be conducive without any artificial hurdles. "A Black Swan [...] is an event with the following three attributes. First, it is an outlier, as it lies outside the realm of regular expectations, because nothing in the past can convincingly point to its possibility. Second, it carries an extreme impact. Third, in spite of its outlier status, human nature makes us concoct explanations for its occurrence after the fact, making it explainable and predictable." — Nassim Nicholas Taleb, The Black Swan: The Impact of the Highly Improbable

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Mr. Neeraj Garg CA Apeksha Kukreja

Valuation of Startups – Art, Science or Conjecture?

The Shark Tank – Season 2 is set to be telecast from 2nd January 2023 and with immense promotions going on in television, recent conversations have revolved around what kind of startups will be participating in this season and their "valuations" and "funding" given to founder entrepreneurs.

The entrepreneurial bug seems to have bitten India hard. "Valuations", "startups", "equity", "funding", "run-rate", etc. are terminology used and understood with ease by folks from all walks of life and not only finance or management professionals.

India is the world's third-largest startup ecosystem. In spite of this positivity, the Indian startup ecosystem raised only ~USD 24 billion till November 2022 as against ~USD 42 billion raised in the entire year 2021[1]. Compared to last year's global unicorns of 542, only 244 new unicorns have been created globally till November 2022, according to data compiled by private market intelligence platform Tracxn Technologies. The number of Indian startups which turned unicorns fell by ~50% on a year-on-year basis from 44 in 2021 to 23 in 2022[2]. With funding drying up, Indian startups have laid ~20,000 employees in 2022[3].

Since the funding winter is expected to worsen in 2023, it becomes increasing interesting to see how many new unicorns are minted in India and globally and how investors reevaluate their parameters to gauge the startups' valuations.

Once again, startup valuations take the center stage amidst globally uncertain and turbulent macroeconomic times

By its very nature, valuation is not an exact science, and more so for valuation of startups, which have their own set of challenges as set out below.

1. https://www.bizzbuzz.news/opinion/india-added-fewer-unicorns-in-2022-what-2023-holds-for-indian-startups-1188228
2. https://www.moneycontrol.com/news/business/new-unicorns-halve-in-2022-as-startup-ecosystem-faces-funding-winter-9764811.html
3. https://www.moneycontrol.com/news/business/startup/indian-startups-laid-off-close-to-20000-employees-in-2022-as-ecosystem-faces-prolonged-funding-winter-9774381.html

Income Approach	Market Approach	Cost Approach
• Small revenues • No historical trend • Going concern issues (possibility of failure) • Difficult to project cashflows in uncertain turbulent marco economic times • Discout rate • Terminal year value	• Niche businesses • Lack of multiples • Size and growth • Illiquidity	• Lack of growth assets • Accumulated losses

Despite the challenges enumerated above, valuers do adopt the traditional discounted cash flows (DCF) under the Income Approach or the Comparable Transactions Method (CTM) under the Market Approach for startup valuations, but these methods have serious limitations to adequately assess the valuation of startups, which differ in their business models, scalability, profitability expectations, funding patterns and instrument profile and lack the financial performance indicators necessary to adopt these approaches for valuation purposes.

With limited historical financial information and uncertain forecasts, qualitative elements play a significant role in startup valuations. Indicators as management experience, customers and revenue, defined target group or a viable product are taken into account in the valuation process.

There are the following valuation methods, which are often used in practice and applied to value startups at different stages of lifecycle. Valuation practitioners may often use a combination of these methods.

Valuation method	Overview of method	Stage of operations	Merits	Demerits
Berkus Approach	Detailed assessment of 5 key factors is carried out (1) Sound business idea, (2) Technology, (3) Quality management for execution, (4) Strategic relationships in its core market and (5) Production and eventual sales. This approach allocates up to USD o.5 million per success factor (for a theoretical maximum pre-money valuation of USD 2.5 million) depending	Pre-revenue stage	The analysis identifies and considers the most basic key value drivers in a startup.	This is a highly subjective assessment and this method puts an artificial cap of USD 2.5 million pre-money valuation of the startup

Valuation method	Overview of method	Stage of operations	Merits	Demerits
	upon the strength of each such factor. The summation of these allocated values for all the success factors becomes the valuation of the startup.			
Cost-to-duplicate	The approach considers all costs associated with the startup - the development of its product, the purchase of its physical assets, etc. All such costs are taken into account to determine the startup's fair market value since an investor will not invest more than what it will take to duplicate the startup.	Pre-revenue stage	This approach considers all resources, at fair value, which are required to commence a similar business as the startup. It is suitable for valuation of cases where future financial performance is difficult to forecast.	The approach is not forward looking as it does not consider the startup's future earning potential. This method lacks in accounting for value of intangible assets (such as brand, patent rights) of the startup.
Scorecard valuation method	The Scorecard Method involves comparison of the startup to others that are already funded but with added criteria. The steps involved in this method include: • Compute the average pre-money valuation of comparable startup companies in the geographical region and industry. • Evaluate the weights to be allocated to the startup (being valued) for the following value drivers: - Strength of the team: 0-30% - Size of the opportunity: 0-25%	Pre-revenue stage, early growth stage	The method is well suited for valuation of pre-revenue/ early growth stage startups where financial information may not be readily available. It considers a comparative assessment of qualitative value drivers along with financial inputs from valuation of comparable funded peer companies.	This method involves a high level of subjectivity in determining the weights to be assigned for qualitative value drivers. High judgement may also be required in assigning comparison percentage to determine advantageous or disadvantageous position of subject startup versus

Valuation method	Overview of method	Stage of operations	Merits	Demerits
	- Product or service: 0-15% - Competitive environment: 0-10% - Marketing, sales channels, and partnerships: 0-10% - Need for additional investment: 0-5% - Other: 0-5% • Assign each quality a comparison percentage i.e. the subject startup compared to other funded startups. If it on par then 100%, below average <100%, or above average >100%, for each quality compared to the comparable funded startups. • The final step is to calculate the sum of the factors adjusted with respective weights. This is finally multiplied with the average pre-money valuation as determined in the 1st step. The Risk Factor Summation (RFS) Approach involves similar analysis as the Scorecard Valuation Method, with a differentiation that RFS Approach considers a deeper and holistic risk factor evaluation and comparison vis-à-vis peer companies making the analysis more nuanced.			other peer funded startups.
Venture Capital Method	For an exit, an investor will either try to obtain a return on his investment aligned with the risk perceived in the startup or seek an exit multiple over and above that implied by his investment.	Early growth and expansion phase	This method is most suited for valuation of startups for which key financial parameters are readily and	While this method involves subjective assessment of a projected financial metric and the investor's ROI, it

Valuation method	Overview of method	Stage of operations	Merits	Demerits
	The method primarily revolves around a defined Return on Investment (ROI) on the VC's investment (generally in the range of 25-60% because of the high risk inherent in the startup). The method involves a three-step approach: • Determine the terminal value of the business in the last projected period. Most often, the projected revenue, EBITDA, or sector-specific parameter is multiplied by the comparable companies' transaction multiple, to arrive at the terminal value of the subject startup. • The terminal value is then discounted by using the appropriate ROI of the investor. • Lastly, the investment value is reduced from the present value of the terminal value (so computed in step 2) to arrive at the pre-money valuation of the startup.		reasonably available.	fails to consider some important non-financial value drivers such as strength of management team, level of competition, product scalability, etc.
Discounted Cash Flows (DCF) Approach	Fraught with challenges to forecast cash flows, this traditional valuation method is often used to value startups. Before adopting DCF for valuation purposes, some of the questions to be resolved are: • For how long the high growth period is expected to last?	Early growth, expansion phase and sustainable growth	Since this is a traditional valuation method, it is more widely accepted and has limited subjectivity. Additional procedures carried out by valuers	When forecasting gets difficult due to dynamic and ever-evolving startup ecosystem, this method may have limited relevance for valuation purposes.

Valuation method	Overview of method	Stage of operations	Merits	Demerits
	• Is there sufficient data to support the growth % projected in forecast? • What will be the margins in the long term? • What discount rate shall the valuer adopt in the interim high/ moderate growth period vs that in perpetuity? In spite of the challenges listed above, valuers often adopt DCF for startup valuations by carrying out additional procedures to draw comfort on projected performance and make substantial modifications to discount rate and terminal growth rate.		on forecast give increased confidence on valuation outcome.	
Comparable Transactions' Multiple Approach	This traditional valuation approach is one the most commonly adopted valuation methods to value startups since it is based on some precedent benchmark. This method is effective only when there are other comparable startups operating in similar geography or industry segment as the target startup. Since these comparable companies operate in early growth or expansion phase or sustainable growth phase, they may attract VC/PE investment and the multiples implied in such transactions can be a useful benchmark to value the target startup.	Expansion phase and sustainable growth	Since this is a traditional valuation method, it is more widely accepted and has limited subjectivity. It is most appropriate to adopt this valuation method when there are similar peer startup companies operating in market with measurable performance metrics.	When minimal operating comparable companies or transactions therein are available, this traditional method cannot be applied for startup valuations.

Risk-return expectations lead to higher discount rates for startups

Stage of development	Plummer	Scherlis & Sahlman	Sahlman, Stevenson, & Bhide
Startup	50%-70%	50%-70%	50%-100%
First stage or early development	40%-60%	40%-60%	40%-60%
Second stage or expansion	35%-50%	30%-50%	30%-40%
Bridge/ IPO	25%-35%	20%-35%	20-30%

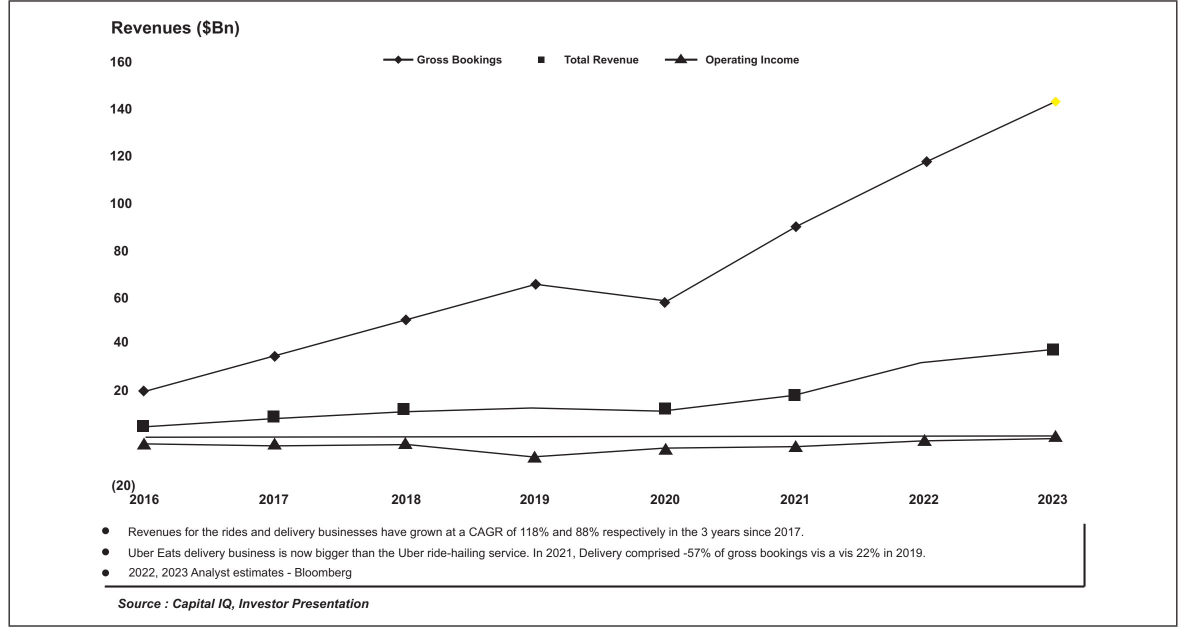
- Start-up-stage investments typically are made in enterprises that are less than one year old. The venture funding is to be used substantially for product development, prototype testing, and test marketing.
- Early development-stage investments are made in enterprises that have developed prototypes that appear viable and for which further technical risk is deemed minimal, although commercial risk may be significant
- Enterprises in the expansion stage usually have shipped some product to consumers (including beta versions).
- Bridge/IPO-stage financing covers such activities as pilot plant construction, production design, and production testing, as well as bridge financing in anticipation of a later IPO.

Source: Valuation of Privately-Held Company Equity Securities Issued as Compensation - Accounting and Valuation Guide, 2013, published by AICPA

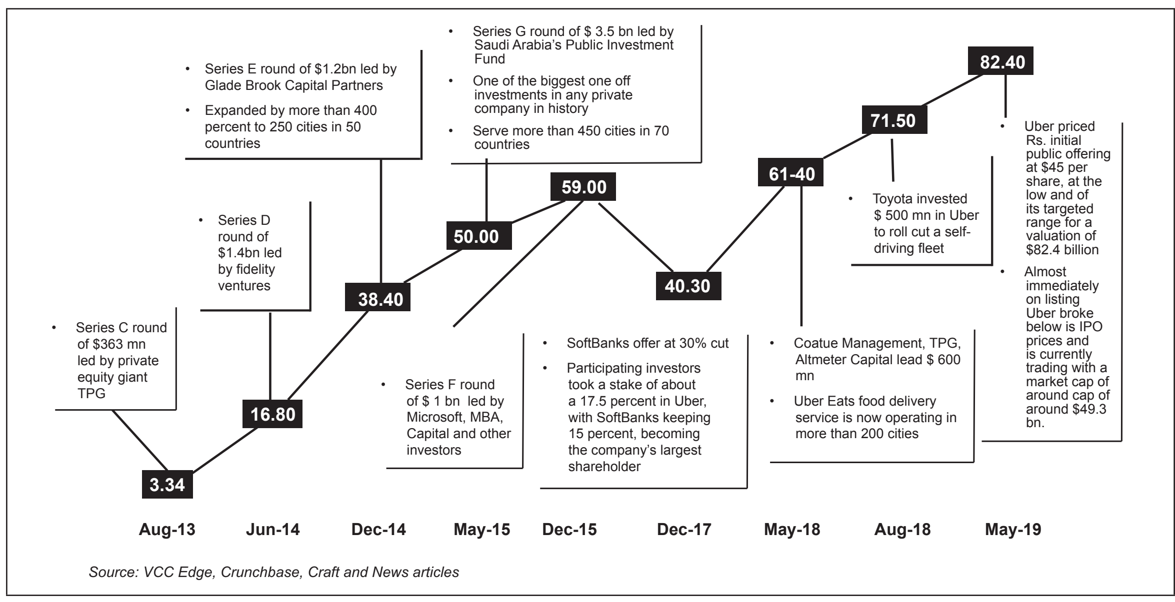
It will be imperative to note that negotiations play a significant role in eventual valuation of the target startup and valuation attributable to different investments categories may differ depending upon characteristics such as liquidation preference, participation rights, conversion terms, etc.

Having discussed some of the practical methods of startup valuations and PE/VCs return expectations from startup investments, let's look at an example of a startup's valuation journey over the years.

Story-line: Uber's pre-money valuation ($ billion)



With twist and turns: Uber's performance story ($ billion)

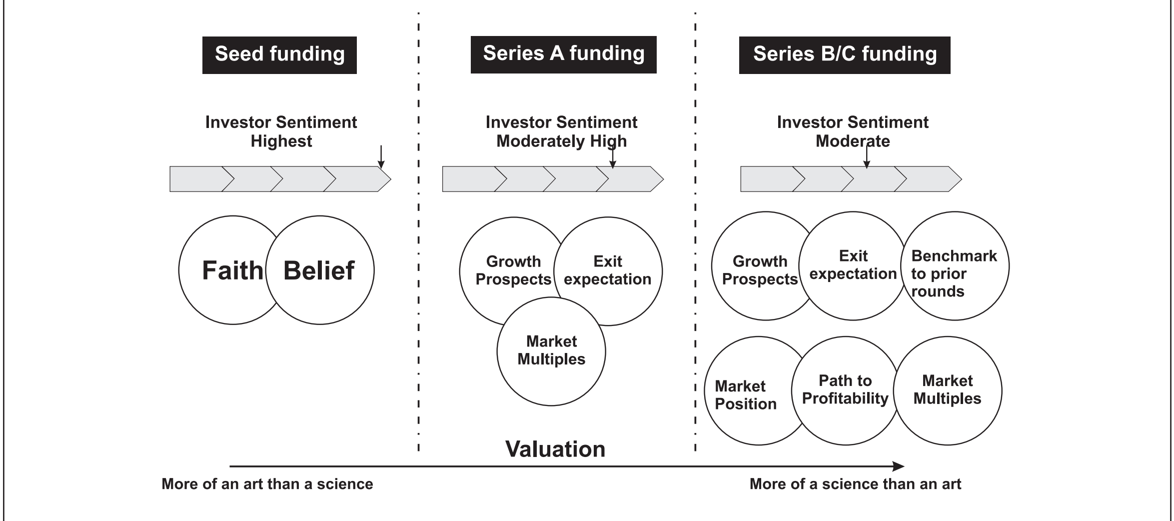


While revenue growth of Uber has been phenomenal (at a CAGR of 32% over 2017-2022), it is yet to turn profitable, with expectations of breakeven in 2023. It is interesting to note that the valuation of Uber rose from USD 40.3 billion in December 2017 to USD 71.5 billion in August

2018 and its equity listed at USD 82.4 billion in May 2019. As at date, the market capitalization of Uber is ~USD 49.3 billion i.e. almost 40% lower than that at time of listing.

We have noted similar rapid uptick and volatility in valuations of other startups like Zomato, Paytm, Oyo, etc.

So is valuation of startups an art, science or conjecture?



Traditional valuation methods find limited application in startup valuations. Other methods (discussed earlier) adopted to value startups are fraught with limitations and challenges. In a dynamic startup ecosystem with newer business models, startup valuation is an evolving process and unusual valuation methods are resultant thereto.

Having said this, investor sentiment, stage of operational lifecycle, level of funding and valuations are very closely intertwined. An investor may value a pre-revenue stage startup purely on a "gut feel" considering faith and confidence in the product/ service and founder team. As the startup matures in its lifecycle and progressively raises funding, valuations take on a "science" approach based on measurable key performance metrics. Hence, startup valuations run the entire spectrum of "art" to "science" in an ever-evolving startup ecosystem and may seem like conjecture sometimes.

> "Be not Afraid of anything. You will do Marvelous work. it is Fearlessness that brings Heaven even in a moment."
>
> — *Swami Vivekananda*

CA Vijay A M

Funding Options for a Start-up

Starting a business is at once both a challenging and an exciting venture. Money is the lifeblood of any venture and capital raise and deployment is a key factor for success. It is important for entrepreneurs to carefully consider their funding options to ensure that their business has the resources it needs to succeed. In this article, we will delve into the various funding options available to start-ups in India.

When it comes to raising capital for your business, there are two key factors to consider: the Source of Funding and Types of Funding Instrument i.e., the form in which you will be raising the money.

Sources of Funding

Today, the start-up scenario in India is quite vibrant and there are multiple sources available at various stages of a start-up. Below is a broad listing of the most common sources at various stages of a start-up:

- **Seed Stages:** The seed stage is the very beginning of a start-ups' journey. At this point, the business is still in the ideation and validation phase and may not even have a fully developed product yet. However, even in these early stages, funding is often needed to build prototypes, test the product with target users, and get the business off the ground. One common source of seed stage funding is the founders themselves. They may use their personal savings and resources, as well as their skills and time, to fund the initial development of the business. In addition to self-funding, there are several other options for start-ups seeking seed stage capital:

  o ***3Fs:*** Promoters also knock doors of the 3Fs – friends, families, and fools! Those who know promoters closely and are willing to bet small amounts of capital to back their vision.

  o ***Angel Investors:*** An angel investor is an individual who provides financial support to a start-up in exchange for equity in the company. Angel investors are often successful entrepreneurs themselves, and they may provide valuable mentorship and guidance in addition to funding. It can be difficult for start-ups to attract angel investors, as these individuals are usually looking for businesses with a proven track record or a unique and innovative product or service.

- o ***Crowdfunding*** is the process of raising small amounts of money from a large number of people, usually through an online platform. There are several crowdfunding platforms available in India, such as Ketto, wishberry, and fueladream, which allow entrepreneurs to pitch their business idea and receive funding from a large number of backers. Crowdfunding can be a great way for start-ups to raise funds and build a community of supporters, but it can also be a challenging and time-consuming process.

- o ***Incubators and accelerators*** are programs that provide support and resources to start-ups in exchange for equity in the company. These programs often provide mentorship, office space, and access to a network of industry experts and potential investors. Incubators and accelerators can be a great way for start-ups to get off the ground and gain traction.

- **Growth Stages**: As a start-up moves beyond the seed stage and begins to establish a product-market fit, it may find itself in need of additional funding to take the product to a larger customer base. This is known as the growth stage, and it is a crucial time for any business looking to scale.

  During the growth stage, a start-up will typically need funds to formalize its product and make it ready for mass market adoption. This may involve refining the product's design, building out the supply chain, and increasing production. To support these efforts, many start-ups turn to Venture Capitalists ('VCs') for funding. VCs are professional investors who specialize in providing capital to high-growth companies in exchange for ownership equity.

  Bootstrapping - in addition to VC funding, a start-up that is generating revenue may also be able to leverage customer advances and vendor credit lines to support its growth. By using these resources wisely, a business can secure the funds it needs to take its product to the next level and continue expanding its reach.

- **Late Stages:** As the start ups become more mature, their existing businesses may be less capital intensive or may even be generating cash. But at this stage capital is required to expand into newer geographies, build new products, vertical & horizontal integrations. During the late stage, the risk associated with investing in a start-up is lower, but the size of the capital needed is often much larger in proportion to the size of the business. This is the stage where private equity firms and commercial banks become major players, providing large sums of capital to support the growth and expansion of the company. While the late stage can be a challenging time for any business, it is also an opportunity to solidify the company's position in the market and lay the foundation for future success. By securing the right funding at this stage, a start-up can gain the resources it needs to continue expanding and driving growth.

  Across these stages, there are several types of instruments available to the start up. Start-ups have a variety of funding instruments to choose from, and the best option will depend on the needs and goals of the specific

business. Key factors driving the type of instrument to be issued include – willingness to part with ownership, predictability of cash flows, the certainty of returns, etc. It is important for start-ups to carefully consider the terms and conditions of any funding they pursue, as well as the potential impact on the ownership and control of the company.

Types of Funding Instruments

- **Equity**: The most basic form of equity funding is to raise money by issuing shares in the company. The shares may be Ordinary Shares with rights similar to everyone else or Preference Shares.

  Preference Shares are generally preferred by Venture Capital and Private Equity investors as they offer more flexibility in the structuring of terms. Some of the common structuring used in preference shares are triggers for conversion (E.g., IPO, change in control), liquidation preference (that their basic investment be paid first), anti-dilution (a certain shareholding % be maintained in case the next round of fundraise happens at a lower valuation), varied voting rights, minimum IRR etc. These terms can help protect the interests of the investors and ensure that their investments are compensated appropriately.

  Another form of equity funding is issuing Equity in return for services – for example Stock Options, Warrants or RSUs that are issued to employees, advisors, or vendors in return for their services. These offer an option to the option holder to participate in the gain in shareholder value. They may exercise these options by paying a nominal/predetermined exercise price to convert their option/warrant into an equity share.

  SAFE: Simple Agreement for Future Equity or SAFE instruments are issued in return for future equity. At the time of issue of SAFE, no dilution or valuation is conducted. The conversion to equity or preference share happens on a future event like the next fund raising, liquidation event etc. SAFE is more common among seed stage investments in US based start-ups.

- **Debt**

  While debt isn't easily available to start ups, they do come in multiple forms and often comes at a higher rate of return to compensate for the higher risk taken by the lender. Some of the common forms of debt available are:

  o ***Venture Debts*** are raised along with an equity financing round to increase the size of the funding round without further diluting the share capital. Venture Debts are usually in form of a term loan with periodic repayments or a bullet repayment. They carry a higher rate of return and are unsecured.

  o ***Working Capital & Term Loans***: commercial banks offer revolving working capital or term loans against collaterals. The collaterals may be in form of receivables, machinery, or land. Funds/banks also have built products that suit start-ups by financing future cashflows from customer contracts, lifetime value of customers etc. While commercial banks are slow to offer loans to start ups and take time to build the trust, they are often the cheapest sources of capital.

- **Tokens**

  Token based fundraising are done in the Web-3 ecosystem where each token represents a share in the overall pool of tokens in a blockchain traded fund. Funds are raised by issuing Tokens from the overall pool of tokens. For investors, these tokens are akin to shares and carry voting rights in the token ecosystem. Their return increases along with the value of the tokens in the market and may also get dividends in form of 'gas fees' that the token system earns. This mode is supported by a few jurisdictions outside India. Bringing in regulatorily support in India can open doors for start-ups in India.

- **Grants**

  Grants are available from various agencies – Government or Non-Government - who are promoting start ups or promoting certain research spends. Most Grants are free of financial costs – no ownership stake, no need to return the grant or zero interest loans. But they usually come with certain conditions on where they can be spent and will need end use reports to be submitted to the grantor.

- **Convertible Notes**

  Convertible notes are quasi debt/equity. In the initial period, they carry a minimum return and at a later point, they may be converted (either by the issuer or by the company) into equity/preference at a pre-agreed valuation. Convertibles generally offer more flexibility to the investor by offering both protection in the capital, minimum return and an upside if the start up works well.

- **SPAC based listing**

  Special Purpose Acquisition Company or SPACs are shell companies formed to make the listing process easier for start-ups. SPACs raise money from public with a promise to acquire a start up in near future. For start ups the listing process becomes easier by reverse merging with the SPAC and they will end use the funds raised by the SPAC. SPAC process does not waive off documentation required in a listing process; it just makes the entire process more certain, and time bound.

In conclusion, start-ups have a variety of funding options available to them, including venture capital, angel investors, crowdfunding, and loans from traditional financial institutions. It is important for founders to carefully consider their options and choose the one that best aligns with their goals and needs. It may also be helpful to seek the advice of a financial advisor or attorney to ensure that the chosen funding option is the most beneficial for the long-term success of the start-up. Regardless of the path chosen, it is crucial for founders to have a solid business plan in place and to be proactive in seeking out potential funding sources.

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"Do one thing at a Time, and while doing it put your whole Soul into it to the exclusion of all else."

— *Swami Vivekananda*

CA Jignesh Kenia

Exit Considerations and Options

To better understand the emerging asset class of 'start-ups', let's take a step back and examine it more closely. Regarded as the **Riskiest** asset class because of its inherent nature, the most important attribute associated with this asset is **Patience**. This asset is for investors who are looking at **Long term** investment plans and have a **long-term view**. **Returns** should also be expected over a longer period. One helpful strategy for investing in start-ups is to adopt a **portfolio approach**, which involves using a systematic and data-driven process to select start-ups that offer a good balance between maximizing returns and minimizing risk in uncertain environments. This is important because no one knows which start-up is going to succeed. **Always invest in great businesses run by great founders at a fair valuation.**

When it comes to exit, what considerations should be borne in mind

For a start-up, its exit value gives investors an idea of how much their investment could be worth over a longer duration. Exits provide capital to start-up investors, which can then return the money to their limited partners (in the case of Venture Capitalists) or to the investors themselves (in the case of business angels). This estimated amount is considered to be most reliable if the proceeds are derived from an independent third party in an arm's length transaction where the sale is not rushed. When a start-up is first created, the primary focus is typically on generating revenue and building a customer base. However, it's important for start-ups to also think about their **exit strategy** and calculate their exit value for several reasons:

1. ***Attracts investors***: Potential investors want to know the company's value so they can assess the risk involved in investing. A high exit value means there is potential for a large return on investment, which can attract more investors.

2. ***Capital raising***: Exit values can be used as collateral when start-ups seek to raise additional capital. A company with a high exit value can secure a higher investment or loan amount.

3. ***Business insights***: Exit value can provide valuable insights into the business's worth and how it compares to others in the industry. This helps with strategic decisions about the business's future.

4. ***Fundraising estimate***: If a start-up knows that its exit value is INR 50 crores, it will be much easier to raise money from investors than if its exit value is only INR 5 crores.

5. ***Focused efforts***: When a start-up knows that it needs to generate INR 50 crores to have a successful exit, then it will be much more likely to focus on high-value activities that will generate that amount of money.

6. ***Negotiation power***: Exit value is often used as a starting point in negotiations, giving start-ups leverage in discussions with potential partners or buyers. The higher the value, the more negotiating power. E.g. If a startup knows that its exit value is INR 50 crores, it will be in a much better position to negotiate with potential acquirers than if its exit value was only INR 5 crores.

7. ***Attract top talent***: If top talent knows that a startup has the potential to be sold for INR 50 crores, they will be much more likely to join the company than if the exit value was only INR 5 crores.

Valuation

Startup valuations provide insight into a company's ability to use the new capital to grow, meet customer and investor expectations and hit the next milestone. There are more than 100+ unicorns (businesses valued at $1 billion+), followed by "decacorns" (valued at $10 billion+) and even "hectocorns" (valued at $100 billion+). The valuation accounts for several subjective factors such as product quality, assets, business model, total addressable market, competitor performance, market opportunity, goodwill, management expertise, quality of team etc. When the company is generating revenue, it becomes the starting point of valuation. In the context of fundraising, the company is ultimately worth what the promoters and investors agree upon. In the majority of cases, angel investors and VC firms use multiple formulas to arrive at the pre-money valuation. Valuations will differ across locations, industries and years. For example, a Bangalore-based tech startup founded in 2002 will have a different value from Pune based food startup in 2020. A B2B company may have dramatically different inputs than a B2C company.

Below are some of the commonly used valuation methods:

a. Market method/Comparable transactions method

If a company is an acquisition target or can be sold in the near future, the market approach is used comparable transactions of listed companies are analysed. The Comparable Transactions Method is one of the most popular startup valuation techniques because it's built on precedent. The first step is to analyse comparable transactions or companies. When researching comparables, following points can be considered:

- Evaluate recent transactions of the past 3 to 5 years
- Comparable companies should be selected from similar or related sectors with a similar revenue generation model, business model and risk profile, a common target region and without a large debt
- Unicorns should be preferably excluded
- Focus should be on Exit Multiples rather than Early-stage Funding Multiples or Multiples of stock-listed companies
- When sufficient Exit Multiples are not present, it's also appropriate to use Late Stage Funding multiples or values of Recently Stock-listed Companies

With any comparison model, factor in ratios or multipliers for different parameters between the two businesses. Eg if another SaaS company has proprietary technology and the company to be valued doesn't, the multiplier on the lower end of the range can be considered. For startups, Revenue or User multiples are prioritised or alternatively other sector-specific growth measures:

b. Discounted cash flow method.

Businesses can also be valued using the Discounted Cash Flow (DCF) Method. Take the forecasted future cash flows and then apply a discount rate or the expected rate of return on investment. Generally, the higher the discount rate, the riskier the investment and the growth rate needs to be better. The idea behind this is that investing in startups is a high-risk move compared to investing in businesses already operating and earning consistent revenue.

c. Venture capital method

If a pre-revenue valuation is required, this method can be considered. There are two formulas:

- Anticipated Return on Investment (ROI) = Terminal Value ÷ Post-Money Valuation
- Post-Money Valuation = Terminal Value ÷ Anticipated ROI

Either calculate the startup's terminal value or the expected selling price after the VC firm has invested. One can find this using estimated revenue multiples for the industry or the price-to-earnings ratio. Determine the anticipated ROI, such as 10x and plug everything in to find the post-money valuation. From there, subtract the investment amount to get the pre-money valuation.

d. Book value method.

This method gives an asset-based valuation. Traditionally, a startup company's book value is its total assets minus its liabilities. In other words, the Book Value method equates the net worth of the startup with the valuation.

e. Scorecard valuation method

The Scorecard Method is another option for pre-revenue businesses. It also works by comparing the startup to others that are already funded but with added criteria.

- o find the average pre-money valuation of comparable companies.
- o Then consider how your business stacks up according to the following qualities.
  - Team Strength: 0-30%
  - Opportunity Size: 0-25%
  - Product/Service: 0-15%
  - Competitive environment: 0-10%
  - Marketing, sales channels, and partnerships: 0-10%
  - Need for additional investment: 0-5%
  - Other: 0-5%

Assign each quality a comparison percentage. E.g. give the ecommerce team a 150% score because it's complete, fully trained, and has experienced developers and marketers, some from rival businesses. Multiply 30% by 150% to get a factor of 0.45.

This is to be done for each startup quality to find the sum of all factors. Finally, multiply that sum by the average valuation in the business sector to get a pre-revenue valuation.

f. **The Berkus Method**

The Berkus Method was created by venture capitalist Dave Berkus to find valuations specifically for pre-revenue startups, i.e., businesses not yet selling their products at scale. The idea is to assign value to five key success metrics found in early-stage startups. The simple formula helps founders and investors avoid faulty valuations based on projected revenues, which few new businesses meet in the expected time period.

No single valuation method is accurate all the time. In the case of start-ups, the multiple method is the most popular and widely used compared to any other method. It's important to benchmark other company databases to ensure the right ballpark. Finally, the valuation is locked between the promoter/owner and the buyer when the actual negotiation takes place.

One can use databases like Crunchbase, Tracxn, VC Circle, Bloomberg, etc to directly compare the valuation to similar businesses or check online indexes and public business reports.

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Timing

As you are aware, a startup investment is a highly illiquid asset. Hence, when an opportunity to exit is received, one should consider it seriously. While there is no single answer as to when the best time is to exit a startup investment, there are several factors which Investors should consider when making their decision.

1. ***Long-term prospects***: Investors who believe in the company's vision and long-term growth potential will likely want to stay invested for longer than those who are looking for a quick return on their investment. It's important for investors to assess the company's current performance, future plans, and potential obstacles to determine if the investment is worth their time and money.

2. ***Market trends and conditions***: Investors should pay attention to the overall market conditions and how they might affect the company's performance. If there is a downturn in the industry or economy, staying invested in a startup may be riskier than exiting. Similarly, if the industry or economy is booming, staying invested may be more beneficial.

3. ***Potential returns***: Investors should have an idea of what kind of return they are hoping to get from their investment and when they expect to get it. If the company is not meeting the investor's return expectations, then it may be time to exit the investment.

4. ***Investor's goals and objectives***: Different investors have different goals for their investments and it's important for them to assess whether their goals are being met by staying invested in the startup. If their goals are not being

met, then it may be time to exit the investment.

While there is apprehension for the investors, the same dilemma exists even for the startup owners/promoters, what is the right time to exit?

- o Startups want to sell for as much money as possible (so do investors) and buyers want to spend as little as possible, so both parties need to find a balance.
- o Startups should look for an exit when their growth rates are high instead of when they're very profitable. This will help maximize their selling price.
- o However, as Business Insider recently explained "lower-valued startups take less time to scale and less VC money to fuel, which means founders will likely own higher percentages of their companies when they sell". This implies that these founders might be better off selling for INR 20 crore when they own a big chunk of the startup instead of waiting for an INR 200 crore price tag, as by then they might only own a small percentage of the stock.

At the end of the day, every owner and investor should consider the circumstances of their ventures and make an informed decision.

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Restrictions

Generally, restrictions for the Founders are captured in the Share Holder's Agreement which details the exit restrictions. Therefore, the owner/promoter/founder should navigate various legal aspects when exiting an investment.

- o Rights & obligations: Firstly, all parties involved in the investment should evaluate the legal rights and obligations. It will be helpful to understand the terms of the agreement established at the time of making the investment. Also, evaluate any applicable laws and regulations governing the investment. Look at any potential liabilities expected to arise from the actions of either party and make sure that any necessary documents are properly executed.
- o Plan exit strategy: Understand the mechanism to sell or transfer the investment, related tax implications, and any financial obligations arising out of the exit. There can also be a probability of disputes arising between the parties involved or regulatory violations.
- o Paperwork/documentation: Typically exit transactions require extensive paperwork to be completed correctly. Hence, it is imperative that all necessary documents are signed and executed after thorough checks, and any necessary fees are also paid.

One should be mindful of the applicable laws and regulations and ensure that all compliances are met.

https://fastercapital.com/content/When-is-the-best-time-to-exit-an-investment-in-a-startup.html#Navigating-Legal-Aspects-When-Exiting-an-Investment

Exit options

Whilst startup investments are risky, they can be very rewarding if and when the investments do pay off. As every investment is always from a return perspective, returns

in start-ups come in the form of Exits. While investors are rooting for and supporting your business, they are also looking for a return on their investment.

Below are the various stages of funding in the lifecycle of a startup:

1. Friends & Family funding
2. Accelerator and Incubator funding
3. Seed/Angel Investment
4. Series A, B, C, D, E etc. – Venture Capitalists and Private Equity investors
5. IPOs
6. Corporates including M&A
7. Strategic acquisitions

The exit value of a company must be mutually agreed upon between all parties and will depend on:

- the type of operation
- the number of shares sold
- the original valuation of the company

Various exit modes for Startups

Exit strategies are a very critical part of undertaking investments, for both private equity players and strategic business investors. The investment horizon is typically pegged to 6-8 years. Also, the exit mechanisms are not always time bound and are often articulated as remedies available to the investor, owing to default/breach by the investee company or key promoters, thus triggering a possibility of an early exit.

o ***Subsequent and higher fundraises***

Some companies don't achieve financial sustainability and hence raise additional funds at various stages. Starting from seed capital to various levels of Series funding, every Series can provide an exit opportunity to the existing investors. At every stage of funding, the subsequent buyer can provide an exit opportunity to the previous investor. e.g.:

- Accelerators and Incubators can evaluate exit options at the seed/angel investment round and any other investment opportunity post that viz Series funding or IPO or corporate funding.
- For a seed and angel investor, typically exit could come in Series A and later rounds. The VC and PE prioritise on easing the cap table/equity holders. That is where they give exits to angel investors.
- PE/VC can look at exit options through additional funding rounds or IPOs or even any strategic investment.

o ***IPO***

IPO is a preferred exit route by investors as it provides access to public markets and enhances access to liquidity. It can also be a secondary form of exit for other investors across other companies by taking part in a buy-out. An IPO may be implemented through an offer for sale of existing shares or a fresh issue, or a combination of both, in onshore or offshore stock exchanges. IPOs with pre-determined conditions like pricing, minimum valuation etc are, for ease of reference, often termed as 'qualified IPOs'. IPO clauses should be articulated to provide sufficient flexibility to the investor, to realign its exit strategy, if need be.

- ***Small and Medium Enterprises (SME) IPO***

  For small-size entities where the promoters can provide an early exit to the investors, SME IPOs are an attractive proposition. NSE EMERGE and BSE SME Exchange are two platforms in India where small and medium size entities can reach out to the public to subscribe to their IPO. It is a hassle-free and fast route to tap the market, where SEBI approval is not required. The post-issue paid capital of the company must not exceed INR 25 Crore to be eligible to list on the SME exchange.

- ***Buyout by founders***

  Buyback means the repurchase of shares. The company purchases its own shares from existing shareholders if the promoters believe that the existing investors may not be able to add incremental value towards the growth of the business or provide any strategic inputs for the future.

- ***PE Investment/Private Sale (Strategic Sales, Trade Sales or Third-Party Sales)***

  This exit route is primarily independent of promoter intervention. Any limitations on private sales are largely contractual, such as co-sale rights, ROFR-ROFO obligations, put and call options etc., which typically do not entail any complicated processes/ obligations on the investors. Investors may also consider a secondary buy-out by selling their stake to other strategic or financial investors/funds.

- ***Merger or acquisition***

  The startup can exercise the option to merge with or get acquired by another company, should cash flow or liquidity become an issue. Mergers typically entail court processes, whereas an acquisition may either be executed by way of an asset sale or entity sale.

- ***Put option***

  While put option clauses have faced the ire of Indian regulatory authorities, the developing jurisprudence trends in India have shown the willingness of the Indian courts to side with the investors. The Indian courts have time and again upheld the validation of put options, which is evident from the judgement of the courts in NTT Docomo Inc. v. Tata Sons Ltd., where it was opined that there exist no provisions under the Indian foreign exchange control laws which absolutely prohibit contractual obligations from being performed.

- ***Cash cow***

  Cash cows are firms that can command a high market share in an industry dominated by low growth. They can sustain enough capital to stay afloat for the foreseeable future as they promise years of increased profits. The promoters select to pay off the investors and sometimes use the remaining cash to develop their next great idea.

- ***Liquidation***

  Typically, small business owners choose liquidation as their "glide path" out of ownership. It enables owners to avoid making difficult choices and slowly unwind the business, living off revenues instead of reinvesting them and closing down when the business no longer turns a profit. Assets are then sold, debts are paid and if anything's left, it goes to the former owner.

o ***Employee Stock Ownership Plan (ESOP)***

An ESOP offers a unique path that allows a business owner to sell, transferring ownership of all or part of a company by setting up an ESOP trust, which becomes the legal entity that holds shares of company stock on employees' behalf. The sale can be structured using borrowed funds, or it can be seller-financed or some combination. Selling a business to an ESOP helps ensure a predictable timeline for the sale and control over exit and succession planning preferences. Besides that, ESOP sales have mechanisms in place to ensure a fair price for the company.

o ***Management buy-out***

In an MBO, the management of the company buys/purchases the assets and operations of the business they manage. This type of exit strategy is favoured by large corporations looking to sell individual divisions that are not part of their core business or by private businesses whose owners wish to retire. An MBO allows a company to go private in an effort to streamline its operations and improve profitability.

o ***Friendly Buyout***

Family succession often involves selling the business to children and it's not an uncommon choice among small business owners. But things can get messy combining those relationships with conversations about price, timelines, management succession, and more. When not all siblings are interested in a business, further complications can arise. The same can go for close friends.

Given the dynamic nature of the Indian economy and the changing market trends, it is key for investors to articulate flexible exit strategies which do not restrict them to take advantage of other viable exit opportunities, which may present themselves over the course of time.

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CA Vijay Gilda

Exchange Control Regulations governing Investing in Start-ups

1. Introduction

An Indian entity wishing to raise funds from outside India needs to comply with the exchange control regulations.

The exchange control regulations provide the rules and regulations governing the modes of investing, with respect to the form of entity (private company, LLP, partnership firms etc.), the routes of funding, the valuation requirements, reporting requirements, the sector in which the funds can be raised etc.

An Indian entity can raise funds from outside India in various forms like equity, debt, quasi debt etc.

The exchange control regulations in India are governed by the Foreign Exchange Management Act, 1999 ('FEMA Act'). The FEMA Act grants powers to Central Government and Reserve Bank of India ('RBI') to regulate the transactions involving foreign exchange. Central Government and RBI regulates the same by issuing Rules, Regulations, Notifications etc

The regulations differ basis the modes of raising funds, the entity raising funds, the sector in which the investee entity operates etc. For example, if an entity wishes to issue equity capital to a non-resident, then, there are one set of regulations (Foreign Investment regulations) that are applicable. However, if the funding is to be raised in the form of pure debt (let's say, external commercial borrowings) there are other set of regulations that are applicable. Therefore, in that sense, raising funds from outside India require compliance of various exchange control regulations.

For the purpose of this article, I have restricted the scope of exchange control regulations applicable with respect to foreign investment in an Indian entity which is either a private limited company registered under the Companies Act, 1956/Companies Act, 2013 ('hereinafter referred to as Co. Act') whose securities are not listed ('hereinafter referred to as Private Company') or a limited liability partnership ('LLP') registered under the LLP Act, 2009.

Therefore, while there could be other forms in which foreign investment can be raised under the exchange control regulations, like units of

REITs, Depository Participants, listed instruments etc., the same are not discussed in this article. Further, apart from the exchange control regulations, implications under the other laws like tax laws, Co. Act etc. needs to be complied or thought through. However, given the scope of this article, the same are not discussed.

2. Foreign investment

- Foreign investment in a Private Company and LLP is governed by the following regulations/rules:

  — Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, issued by Central Government (hereinafter referred to as 'NDI Rules')

  — Foreign Exchange Management (Mode of Payment and Reporting of Non-Debt Instruments) Regulations, 2019 issued by RBI.

  — Consolidated FDI policy issued by Department for Promotion of Industry and Internal Trade ('DPIIT')[1]

  For this article, all the above are together referred to as 'NDI Regulations'.

- As per the NDI Regulations, a 'Foreign investment' is defined to mean any investment made by a person resident outside India ('PROI') on a repatriable basis[2] in equity instruments of an Indian company or to the capital of an LLP.

- A Foreign Investment can be made in a Private Company or an LLP, in the following manner:

  a) Foreign Direct Investment ('FDI') – Investment in equity instrument by a PROI in an unlisted company – NDI Regulations read with Schedule I of the NDI Rules

  b) Investment in LLP – Investment in the capital or share of profit share of an LLP – NDI Regulations read with Schedule VI of the NDI Rules

  c) Foreign Venture Capital Investor ('FVCI') route – Investment by Foreign Venture Capital Investor registered with SEBI (Foreign Venture Capital Investor) Regulations, 2000 - NDI Regulations read with Schedule VII of the NDI Rules

3. Key regulations governing Foreign Investment

Under the NDI Regulations, a Private Company or an LLP which wish to avail foreign investment, needs to be mindful of the following key parameters, which are subsequently discussed at length in the article.

a) Types of instruments

b) Sector in which the Investee entity operates

c) Routes of Investment - Automatic route and Approval route

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1. The latest FDI policy was issued on 28 October 2020 with effect from 15 October 2020.
2. Investment on repatriation basis means an investment, sale or maturity proceeds net of taxes are eligible to be repatriated outside India.

d) Manner of investment and repatriation of funds

e) Valuation norms

f) Filing requirements

Given that this article focuses on two types of legal entity i.e., Private Company and an LLP, for better understanding of the above parameters for each type of entity, the discussion is bifurcated basis the entity type.

4. Private Limited Company – FDI investment

4.1 Types of instruments

- An investee entity can raise funds in the form of FDI by way of issuing equity share capital, compulsorily and mandatorily convertible preference shares (‘CCPS’) and compulsorily and mandatorily convertible debentures (‘CCDs’).

- Raising funds in any other form like optionally convertible debentures, optionally convertible preference shares would not be regarded as FDI and would fall under the category of External Commercial Borrowings (‘ECBs’) and would be governed by the ECB regulations, except convertible notes raised by an Indian start-up company (‘hereinafter referred to as ‘Start-up Company’), which is discussed below.

- The equity shares can be partly paid subject to the condition that the balance paid up capital of such partly paid-up shares should be fully called upon within 12 months of such issue or as may be specified by RBI from time to time. Twenty-five per cent of consideration (including share premium, if any) shall be received upfront.

- A CCD or CCPS can have an optionality clause subject to a minimum lock-in-period of one year or as prescribed for the specific sector, whichever is higher, but without any option or right to exit to the Investor at an assured price.

- Share warrants can also be issued subject to compliance of the conditions under the Co. Act, or any other applicable law. At least 25 per cent of the total consideration amount (including share premium, if any) should be received upfront.

Issue of convertible note by a Start-up Company

- Under the FDI regulations, an Indian start-up company can issue a convertible note subject to certain conditions.

- Start-up Company under the NDI Regulations is defined to mean a private limited company incorporated under the Companies Act 2013 and identified under Notification no. G.S.R. 180(E), dated the 17th of February 2016[3]

3. Notification providing conditions for recognizing as Startup entity. This notification has been superseded by other notifications. While no amendment has been brought into the NDI Regulations giving reference to other notifications as well, a practical view could be that a private limited company registered as start up as per the other applicable notifications, should also be eligible to be regarded as ‘Start-up Company’ for the purpose of eligibility to issue convertible notes under the NDI Regulations.

issued by the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry ('DIPP Notification').

- An important point to be noted here is that for the purpose of NDI Regulations for a start-up entity to be eligible to issue convertible note, the entity should be a private limited company registered under the Co Act. A start up entity which is formed as an LLP under the LLP Act would not be eligible to issue convertible notes, though an LLP form of entity is eligible to be registered as a start-up entity under the DIPP notification.

- Convertible note means an instrument issued by a Start-up Company acknowledging the receipt of money initially as debt, repayable at the option of the holder, or which is convertible into such number of equity shares of that company, within a period not exceeding ten years.

- A start-up company can issue a convertible note subject to the following conditions:

  — The convertible note should be issued for an amount of twenty-five lakh rupees or more in a single tranche.

  — If the sector, in which the Start-up Company is engaged requires prior approval of Government of India for foreign investment, then, even for issue of convertible notes prior approval of Government of India is required

  — Issue of equity shares against such convertible notes shall be in compliance with the entry route, sectoral caps, pricing guidelines and other attendant conditions for foreign investment.

  — A person resident outside India ('PROI')[4] may acquire or transfer by way of sale, convertible notes from or to a person resident in India ('PRII')[5] or outside India, provided the transfer takes place in accordance with the entry routes and the pricing guidelines as prescribed for capital instruments.

4.2 Sector in which the Investee entity operates

- It is important to note that to what extent an Investee entity can obtain FDI also depends on the sector in which such investee company operates. In some sectors, FDI is permitted up to 100% and in some sectors, it is permitted below 100% say 49% or 74% and, in some sectors, it is completely prohibited.

- FDI is prohibited in the following sectors:

  — Lottery business, online lotteries etc.

  — Gambling and betting including casinos etc.

4. As defined under FEMA Act
5. As defined under the FEMA Act

- Chit Funds
- Nidhi
- Trading in Transferable Development Rights
- Real estate business or construction of farm houses. Real estate business means dealing in land and immovable property with a view to earn profits from there and does not include development and construction activities, real estate broking services etc.

• Currently, under the NDI Regulations, most of the sectors are permitted to receive 100% FDI under the automatic route. Further, in some sectors, though 100% FDI is permitted under the automatic route, it is coupled with performance linked conditions. For example, sectors like construction and development activities, e-commerce operators etc.

4.3 Routes of investment - Automatic route and Approval route

• There are two modes in which FDI can be made in a Private Company– Automatic route and Approval Route.

• As the name suggests, automatic route would mean no prior approval required for making FDI and conversely, approval route means prior approval of Government of India is required for making the FDI.

• Again, the requirement for automatic and approval route depends on various factors, which *inter alia* include:

- sector in which the investee entity operates
- what is the per centage of foreign investment (existing and proposed) in the investee company
- Is the investment being made by a non-resident from a particular country or national of a particular country.

• Therefore, depending on various factors, the FDI can be under the automatic route or approval route. As an example, generally, 100% FDI is permitted under the automatic route in an entity engaged in in IT consultancy services sector. However, if the investor belongs to a country which shares land border with India or the beneficial owner of an investment into India who is situated in or is a citizen of any such country, then in such case FDI can be made only under the approval route.

• For seeking approval from Government of India, there is a specific process prescribed. The process is an online process and standard operating procedures (‘SOPs’) are also issued for such process.

4.4 Manner of investments and repatriation of funds

• The FDI can be made by a PROI either by way of investing directly subscribing into the investee company or through acquiring (purchasing) equity instruments

from an existing investor (could be person resident of India or person resident outside India).

- In case of direct investment by PROI, the investee company should ensure that it complies with the sectoral caps, valuation norms, reporting requirements etc. Equity Instrument shall be issued to the PROI within 60 days from the date of receipt of consideration. In case of partly paid shares, the 60 days' time limit shall be reckoned from the date of receipt of each call payment. In case, the equity instrument is not issued within 60 days, then, the entire amount shall be refunded to the PROI within 15 days from the end of 60 days.
- In case the investment is in the form of rights issue, bonus issue then, apart from the conditions/ compliances as required to be undertaken under the NDI Regulations, the requirements, and conditions as are applicable under the Co. Act should also be complied with.
- The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in NRE/FCNR(B)/Escrow Account maintained in accordance with the prescribed regulations.
- Further, generally, a PROI can freely repatriate funds including sale proceeds received on transfer of equity instrument, dividend income, interest earned on CCDs, subject to applicable taxes.
- The below table summarises the various modes in which the FDI can be made by a PROI, and funds can be repatriated by PROI on exit of investments or income earned from such investments. It is imperative that the applicable NDI regulations with respect to valuations, sectoral limits, residential status/citizenship of the Investor/transferee etc., should be complied with.

Sl. No.	***Particulars***	***Nature of transaction***
1	Subscription to Memorandum of Association ('MoA') and Articles of Association ('AoA')	PROI to invest as subscriber to MoA and AoA
2	Rights issue by investee company	PROI to invest basis the rights entitlement. Further, a PROI can acquire rights entitlement from a PRII and can acquire shares in the investee company
3	Bonus issue by investee company	No consideration to be paid by PROI
4	Acquisition of equity instrument from PROI	PROI can acquire from PROI
5	Acquisition of equity instrument from PRII	PROI can acquire from PRII

Sl. No.	*Particulars*	*Nature of transaction*
6	Acquisition in a scheme of merger or demerger or amalgamation of Indian companies	PROI can acquire equity instrument being issued by the transferee company or the new company to the existing holders of equity instrument subject to the compliance of the NDI regulations
7	Transfer of shares by PROI to PRII	PROI can transfer shares to PRII
8	Buy-back and capital reduction by the Indian company	It shall be deemed to be transfer from PROI to PRII and all the applicable provisions under the NDI Regulations shall be complied including valuation norms, reporting etc.
9	Dividend income on shares	No limit on rate of dividend under the NDI Regulations. Can be freely repatriated, subject to taxes.
10	Interest on CCDs	No limit on rate of dividend under the NDI Regulations. Can be freely repatriated, subject to taxes.

4.5 Valuation norms

A FDI should comply with the valuation norms.

A. In case the equity instrument is issued by Private Company to PROI:

— the value of equity instrument should not be less than the value as computed under an internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with SEBI or a practising Cost Accountant.

— In case of convertible equity instruments i.e., CCPS and CCDs, the price of conversion formula of the instrument should be determined upfront at the time of issue of the instrument. Further, the price at the time of conversion should not be lower than the fair worked out, at the time of issue of such instruments.

— However, no valuation is required for the shares issued at face value towards subscription to MoA.

— In case of share warrants, the pricing and the price or conversion formula shall be determined upfront.

— In case of rights issue, the price per share should not be less that the value at which shares are being offered at rights basis to the resident shareholders.

— In case of swap of equity instrument – Value should be determined by Merchant Banker registered with SEBI or investment banker

outside India registered with the appropriate regulatory authority in the host country.

B. In case the equity instrument is transferred by a PROI to PRII

— The price shall not exceed the value of equity instrument computed under an internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with SEBI or a practising Cost Accountant.

C. In case the equity instrument is transferred by a PRII to PROI

— The price shall not be less than the value as computed under an internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a Merchant Banker registered with SEBI or a practising Cost Accountant.

4.6 Filing requirements

- On issue of equity instrument – The Investee company shall report the details in Form FC-GPR within 30 days of issue of equity instrument.

- On transfer of equity instrument– Form FC-TRS should be filed within 60 days of transfer of equity instrument or receipt/remittance of funds, whichever is earlier. The onus of reporting shall be on the resident transferor/transferee.

- Annual Filing – The Indian entity shall submit Form FLA to RBI on or before 15th day of July of each year with respect to FDI received in the previous year (i.e., April to March) including current year

- Convertible notes issued by Start-up Company

  a. On issue of convertible note – Start-up Company shall file Form CN within 30 days of issue of such issue.

  b. In case of transfer of convertible notes by a PROI to PRII and vice versa, the PRII shall report such transfer in Form CN within 30 days of such transfer.

5. FDI in LLP

- FDI in an LLP is permitted only in those sectors in which 100% FDI is permitted under the automatic route and where there are no FDI linked performance conditions attached to those sectors/ investments. Let's take an example - While 100% FDI is permitted in construction and development activities, an LLP entity engaged in such activities cannot avail FDI since, such activities have FDI linked performance conditions.

- FDI in an LLP can be made by a PROI, other than (a) citizens of Pakistan or Bangladesh and (b) entities registered as FPI and FVCI.

- Further, FDI in LLP is permitted under automatic route.

- Investment in an LLP either by way of capital contribution or by way of acquisition or transfer of profit shares, should not be less

than the fair value worked out as per valuation norm which is internationally accepted or adopted as per the market practice (hereinafter referred as 'fair value') and the valuation certificate in this regard shall be issued by a Chartered Accountant or practising Cost Accountant or by any approved valuer from the panel maintained by the Central Government. Please note that valuation requirement is applicable even for the initial capital contribution, which is not a requirement for FDI in the private limited company towards subscriber shares.

- In case of transfer of capital contribution or profit share from PRII to PROI, the consideration shall not be less than the fair value and in case of transfer from PROI to PRII, the consideration shall not be more than the fair value.
- Further, a company having FDI can convert into LLP and vice versa, under the automatic route, subject to the condition that transferor entity is engaged in sector in which 100% FDI is permitted under the automatic route and there are no FDI linked performance conditions.
- An LLP cannot issue convertible notes though it may fall under the meaning of 'Start up entity' as per the DIPP Notification, since, under the NDI Regulation only a private limited company which falls under the meaning of Start-up entity as per the DIPP Notification is eligible to issue such convertible notes.
- Reporting requirements
    - — Form LLP (I) – To be filed by LLP received foreign investment within 30 days of receipt of consideration for capital contribution and acquisition of profits share
    - — Form LLP (II) – In case of disinvestment/transfer of capital contribution or profit share between a resident or non-resident and vice versa, Form LLP (II) shall be filed within 60 days from the date of receipt of funds. The onus for reporting shall be on the resident party to the transaction.
    - — Annual Filing – The LLP shall submit Form FLA to RBI on or before 15th day of July of each year with respect to capital contribution received in the previous year (i.e., April to March) including the current year.

6. Investment by FVCI

- A FVCI can invest in securities issued by an Indian company engaged in the below sectors:
    - — Biotechnology
    - — IT related to hardware and software
    - — Nanotechnology
    - — Seed research and development
    - — Research and development of new chemical entities in pharmaceuticals sector
    - — Diary industry
    - — Poultry industry

— Production of bio-fuels

— Hotel cum convention centres with seating capacity of more than 3000

— Infrastructure sector[6]

- The term 'securities' is not defined under the NDI regulations. As per the NDI Regulations, any word or expression used but not defined under the FDI regulations, shall have the meaning assigned to them under the Act, rules, or regulations. Therefore, one can take a view that 'security' defined under the provisions of Foreign Exchange Management Act, 1999 ('FEMA Act') can be considered for the purpose of investment by FVCI under the FDI regulations.

- The term 'security' under the FEMA Act is very broad and covers shares, stocks, bonds, and debentures etc.

- Therefore, a FVCI can investment in a private limited company engaged in above sectors in various forms including optionally convertible securities etc.

- It is interesting to note that FVCI can invest in equity or equity linked instrument or debt instrument issue by an Indian 'start up' irrespective of the sector in which the start-up is engaged. For this purpose, the definition of 'start-up' shall be as per Notification No. G.S.R 364(E), dated 11 April 2018 issued by Department for Promotion of Industry and Internal Trade ('DPIIT')[7].

- If the investment by FVCI is in equity instrument then, the sectoral caps, entry routes and attendant conditions under the NDI Regulations shall apply.

- Another important point with respect to investment by FVCI is that there are no valuation norms prescribed for such investment. Further, even with respect to transfer of securities by/to FVCI, no valuation norms are prescribed. The valuation can be the price agreed between the parties. Further, there are no reporting requirements for investment by FVCI under this Schedule.

- A FVCI can invest under the FDI regulations also. In such case, such investment would be regarded as a regular FDI investments and hence all the applicable conditions including valuations, reporting etc. would apply for such investments.

7. Issue of Stock Options, sweat equity shares and Share Based Employee benefits to PROI

- An Indian company can issue stock options (ESOP), sweat equity shares, and share based employee

6. Meaning given in the Harmonise Master List of Infrastructure sub-sectors approved by Government of India vide notification F.No.13/06/2009-INF, dated 27 March 2012 as amended or updated

7. Notification providing conditions for recognizing as Startup entity. This notification has been superseded by other notifications. While no amendment has been brought into the NDI Regulations giving reference to other notifications as well, a practical view could be that an entity registered as start up as per the other applicable notifications, should also be eligible to be regarded as 'Start-up entity'.

benefits to its employees or directors or employees or directors of the (a) it's holding company or (b) joint venture or wholly owned overseas subsidiary/subsidiaries who are non-resident of India, subject to the Indian company complying with the provisions of Co Act, and the applicable NDI Regulations.

- The Indian company issuing ESOP is required to file Form ESOP within 30 days of issue of ESOP.

8. Downstream FDI or Indirect FDI – An overview

- Under the NDI Regulations, an Indian entity[8] having FDI and is majority owned[9] and controlled[10] by PROI, then, any downstream investment made by such Indian entity is regarded as indirect FDI.
- Such Indirect FDI, needs to be in compliance of the NDI regulations with respect to sectoral caps, valuation norms, entry route etc.
- Indirect FDI cannot be made by borrowed funds. The funds must be brought from outside India, or the internal accruals can also be used to make downstream investments.
- Reporting requirement:
  - — The Indian entity making downstream investment, shall notify Secretariat for Industrial Assistance, DPIIT within 30 days of such investment, even if equity instruments have not been allotted.
  - — Form DI to be filed with RBI by the Indian entity making downstream investment within 30 days from the date of allotment of equity instruments.

9. Non-compliance of the exchange control regulations

The exchange control regulations need to be complied with in form and in substance. Non-compliance of exchange control regulations could invite penalty which can go up to 3 times the amount involved in contravention. There is a framework for compounding of offences. Also, for certain non-compliances pertaining to delay in filing of forms, a late submission fee ('LSF') can be paid, and the non-compliance could be regularised.

Conclusion

This Article attempted to provide an overview of the exchange control regulations that are applicable for foreign investment in a Private Company and LLP. Any transaction involving FDI needs to be carefully evaluated and necessary requirements under the NDI Regulations should be complied with to avoid non-compliance of the regulations.

8. Can be a private limited company or an LLP, basis the scope of this Article.
9. i.e., beneficial holding of more than 50% of equity instrument in a company or contribution of more than 50 percent in capital of LLP and having majority profit share
10. Right to appoint majority of directors or control of management etc.

CA Bhavesh Thakkar

Start-ups – Central and State Incentives in India

In the recent years, start-ups have gained prominence across the globe. There has been a sharp rise in the registrations in India, with close to 73,000 start-ups being recognised as of today. A key contributor to this growth has been the policy support provided by the Central and State Governments. This article discusses the major incentives and schemes provided by the governments.

India has emerged as the 3rd largest ecosystem for start-ups globally. As the country celebrates its 75th year of Independence on a strong foundation for efficiency and growth, acceleration in scientific and technical innovation is driving rapid economic progress throughout the country.

Today, India is experiencing noteworthy transformations, from space technology, digital payment arena and telecommunications, all driven by innovative solutions. India's Chandrayaan-2 Moon orbit, digital identity technologies (Aadhar) and unified payment applications (BHIM, PhonePe,) digital backbone for the vaccination drive (Cowin and Aarogya Setu) and indigenous covid vaccine (Covaxin), are a few prominent examples of the country's current innovation prowess across various sectors.

India has achieved the 40th rank on the Global Innovation Index 2022. This is a huge leap of 41 places in 7 years. India continues to lead the world in the ICT services exports indicator (1st) and holds top rankings in other indicators like venture capital recipients' value (6th), finance for start-ups and scaleups (8th), Graduates in science and engineering (11th), Labour productivity growth (12th) and Domestic industry diversification.

As of 7th September 2022, India is home to 107 unicorns with a total valuation of $ 340.79 bn. A unicorn in the financial world is a startup that is privately owned with a valuation that exceeds $1 billion. Bengaluru is India's unicorn capital with the highest number of unicorns headquarters followed by Delhi (NCR) and Mumbai. While we see unicorns active in Tier I cities, this ecosystem is not restricted and is proliferating across the country.

The state-wise detail of the startups recognized by the DPIIT as on 30th June 2022 is stated below:

Ranking	State	No. of startups
1	Maharashtra	13,519
2	Karnataka	8,881
3	Delhi	8,636
4	Uttar Pradesh	6,654
5	Gujarat	4,920

The major growth drivers have been discussed below.

Support	Growth Drivers	Description
Government Support	Institutional Support	Government collaborations with private incubators, global bodies and educational institutions providing subsidies, incentives, incubation, and mentoring support.
	Schemes, incentives, and initiatives	Government initiatives such as Start-up India, AIM, NIDHI, etc. Such incentives help in the nascent stages for the growth of start-ups.
Cost Benefits	Cost advantages	Lower cost of living leading to savings in cities beyond Tier I.
	Labour Costs	Availability of skilled labour in cities beyond Tier I and cheaper hiring costs
Developing Infrastructure	Growing Internet Penetration	Consistent increase in internet connectivity for reaching a larger audience like remote areas and adoption of 5th generation network.
	Workspace Availability	Ease of doing business with the emergence of co-working spaces and the work-from-home model
Private Funding support	Increased Venture Capital	Increased Venture capital support due to maturing digital infrastructure (Unified Payment Interface (UPI)-led payment trails, easy data access and Aadhar electronic Know Your Customer [eKYC]) thereby increasing depth in the start-up ecosystem.
Education	Premium Education Institutes	These institutes produce innovative entrepreneurs and related ecosystem (Zomato, Snapdeal)

Government Initiatives

Government support is crucial to help start-ups through their life cycle. A detailed summary of the key initiatives undertaken by the Central and State Governments has been given below.

I. Central Government intiatives

To understand the various schemes and incentives promulgated by the Central Government, it is pertinent to first gain an understanding of the definition of start-ups –

As per the revised Gazette Notification No. G.S.R. 34 (E) dated January 16, 2019, an entity shall be considered as a Start-up:

1. **Period** - Period of existence and operations should not be exceeding 10 years from the Date of Incorporation

2. **Type of Entity** – Company should be incorporated as a Private Limited Company, a Limited Liability Partnership (LLP) or a Registered Partnership Firm

3. **Annual Turnover** – Annual Turnover not exceeding INR 100 crore for any of the financial years since its incorporation

4. **Original Entity** – Entity should not have been incorporated by splitting up or recreating an already existing entity

5. **Innovative and scalable** – The entity should be working towards development or improvement of a product, process, or service and/or have scalable business model with a potential for generation of wealth & employment.

The Central Government has taken several strategic initiatives. The key ones have been highlighted below –

A. Start-up India Initiative

B. Atal Innovation Mission

C. National Initiative for Developing and Harnessing Innovations (NIDHI)

D. Start-up India Seed Fund Scheme (SISFS)

E. Pradhan Mantri Mudra Yojana

A. Start-up India Initiative 2016

This is a flagship initiative of the government for the promotion of a robust start-up ecosystem by supporting entrepreneurs and transforming India into a country of job creators instead of job seekers.

The objective of this initiative is to focus on three areas: simplification and handholding, funding support and incentives.

(a) Fund of Funds: Funding support for development and growth of innovation driven enterprises with a corpus of INR 10,000 crore managed by Small Industries Development Bank of India (SIDBI).

FFS does not invest in start-ups directly but provides capital to SEBI-registered Alternate Investment Funds (AIFs), known as daughter funds, who in turn invest money in high-potential Indian start-ups.

Present status: As of April 2022, INR 9,500 crore has been invested in more than 600 start-ups. Commitment of INR 7,225 crore to 86 alternative investment funds.

(b) Credit Guarantee Fund for Start-ups: It is jointly set up by Ministry of MSME, Government of India and SIDBI. Fund and non-fund based (Letters of Credit, Bank Guarantee etc.) credit facilities up to Rs 200 lakh per eligible borrower are covered under the guaranteed scheme.

Present status: Guarantees approved during FY 2022 are INR 56,172 crore with a growth in coverage in terms of amount of 52%.

(c) DPIIT Recognition: To access tax benefits and relaxed compliances, companies have to be recognized as start-ups by the Department for Promotion of Industry and Internal Trade (DPIIT) under the Start-up India Initiative. To apply for recognition by DPIIT the conditions mentioned in Gazette Notification No. G.S.R. 34 (E) must be fulfilled.

Benefits of DPIIT –

1. **Self-Certification** – Entity will be allowed to self-certify compliance under 3 environmental laws and 6 labour laws.

2. **Start-up Patent application** – Entity will be given an 80% rebate of the fees on patents, trademark, copyrights and design and the fast tracking of a patent application will be available as well.

3. **Easier Public Procurement Norms –** Entity will get an opportunity to list the product on Government e-Marketplace and be exempted from submitting Earnest Money Deposit. Government shall exempt Start-ups in the manufacturing sector from the criteria of "prior experience/ turnover" without any compromise on the stated quality standards or technical parameters.

4. **Easy winding up of company -** To encourage entrepreneurs to experiment with new and innovative ideas, without having to face complex and long-drawn exit processes. As per the Insolvency and Bankruptcy Code, 2016, start-ups with simple debt structures, or those meeting certain income specified criteria can be wound up within 90 days of filing an application.

5. **Tax Exemption –** Start-ups can apply for tax exemption for 3 consecutive financial years out of their first ten years since incorporation.

   Present Status: Sustained Government efforts in this direction have resulted in increasing the number of recognized Start-ups from 471 in 2016 to close to 73,000 in 2022 (as on 30th June 2022). Out of these, nearly 47% of them have at-least one-woman director, further generating 8,63,068 jobs. 448 start-ups have also been granted income tax exemption under section 80-IAC of the income tax act.

B. Atal Innovation Mission (AIM), launched in 2016

AIM was launched by the NITI Ayog, to foster innovation and entrepreneurship across educational organisations, research institutes and industries including MSMEs.

Objectives of AIM –

1. To promote innovation by creating a platform, developing programs and policies

2. To provide a platform for entrepreneurs for collaboration opportunities

Initiatives taken by AIM –

(a) Atal Tinkering Labs (ATL)

To nurture an innovative mindset amongst schools across India. The main objective is to generate curiosity, creativity, and imagination in young minds. In present, there are ten thousand and above ATL's in India. There are 60% plus ATL's in government/ government aided schools and 96% in Girls/ Co-Ed Schools.

(b) Atal Incubation Centre (AIC)

An ecosystem of start-ups and entrepreneurs AIM has established incubators across universities, institutions and corporates among

others. The aim of the centers is to foster innovation and support dynamic entrepreneurs who want to build scalable and sustainable enterprises. As of today, there are 69 AICs with 2,900 plus start-ups that have been incubated.

(c) Atal New India Challenge

AIM launched 2nd edition of the challenge in 2022. The challenge aims to seek, select, and support innovators to create products or solutions based on advanced technologies in areas of national importance and societal relevance through a grant-based mechanism of up to INR 1 crore.

The challenge aims to incentivize innovations in areas of national importance like Education, Health, water and sanitation, Agriculture, Food Processing, Energy, etc. Presently, ANIC has received 900+ complete applications. 30 start-ups have been selected and are being supported through grant-in-aid worth INR 22.85 crore and other associated support.

(d) Atal Community Innovation Centre

The launch of these centres was to provide infrastructure and facilitating environment for innovation for underserved/unserved regions of India i.e., grassroots level. Grassroot innovations have been defined by AIM as – 'products and services emerging from innovations brought about by people at the bottom of the pyramid (BOP) who are from economically disadvantaged sections and socially excluded areas.

(e) Aatmanirbhar Bharat ARISE

This national initiative is to promote innovation in a phased manner for start-ups and MSMEs. The intent for this initiative is to collaborate with esteemed Ministries and the associated industries to catalyze research, innovation and to facilitate innovative solutions.

(f) Vernacular Innovation Program

It is an initiative to lower the language barrier in the field of innovation and entrepreneurship such that there is no hurdle for vernacular innovators when learning design thinking and entrepreneurship, accessing markets, etc. To establish this, AIM has identified and will be training a Vernacular Task Force (VTF) in each of the 22 scheduled languages.

C. National Initiative for Developing and Harnessing Innovations (NIDHI)

It is pioneered by the Department of Science & Technology (DST) for nurturing ideas and innovations into successful start-ups.

Objectives –

1. To promote student innovations in Innovation and Entrepreneurship Development Centre
2. To promote student start-ups, focused on creating a smooth and innovation-led ecosystem
3. To accelerate the journey of ideas to initial prototyping by providing initial assistance

Initiatives of NIDHI-

(a) ***Nidhi Prayas*** - Promoting and accelerating Young and Aspiring Innovators and Start-up

The program would target to facilitate and enable minimum 100 innovators annually across the country in translating their ideas into prototype through financial support to maximum 10 PRAYAS Centres (PC) by providing a grant up to INR 10 lakh and an access to Fabrication Laboratory.

(b) ***NIDHI-Technology Business Incubator (TBI)-***Converting Innovations to start-ups

To provide cost-effective, value-added services to start-ups like mentoring, legal, financial, technical, and intellectual property related services.

(c) ***NIDHI-Accelerator-***Fast tracking a start-up through focused intervention

Acts as a centre to fast-track the growth of potential start-ups through rigorous mentoring and networking support.

(d) ***NIDHI-Seed Support System (NIDHI-SSS)-***Providing early-stage investment

To ensure timely availability of the seed support to the deserving,developing startups within an incubator, thereby enabling infrastructure and readiness for the entrepreneurs.

D. Start-up India Seed Fund Scheme (SISFS)

Launched in 2021 by the DPIIT, the primary object is to ensure easy availability of capital to start-ups at the early stages of growth. Assistance is provided by way of grant or debt/convertible debenture to start-ups for proof of concept, prototype development, product trials, market entry and commercialization.

A corpus of INR 945 crore has been set up for disbursement to selected incubators across India in 2021-25.

Present Status:

As on 30th July 2022, of the corpus of INR 945 crore, INR 375.25 crore have been approved to 102 incubators, with INR 81.45 crore being approved to 378 DPIIT recognised startups.

Eligibility Criteria –

1. DPIIT recognised startup incorporated not more than 2 years prior to the date of application

2. The start-up must have a business idea to develop a product or a service with market fit, viable commercialization, and scope of scaling

3. The start-up should be using technology in its core product or service, or business model, or distribution model, or methodology to solve the problem being targeted

4. Preference would be given to start-ups creating innovative solutions in sectors such as social impact, waste management, water management, financial inclusion, education, agriculture, food processing, biotechnology, healthcare, energy, mobility, defence, space, railways, oil and gas, textiles, etc.

5. The start-up should not have received more than INR 10 lakh by

way of monetary support under any other Central or State Government scheme.

6. Shareholding by Indian promoters in the start-up should be at least 51% at the time of application to incubator for the scheme, as per Companies Act, 2013 and SEBI (ICDR) Regulations, 2018.

7. Any start-up will not receive seed support more than once each as per provisions of guidelines.

The above-mentioned schemes have been formulated to support startups recognised by DPIIT whereas the Mudra Scheme described below is applicable to emerging micro enterprises in India.

E. *Pradhan Mantri Mudra Yojana*

Micro Units Development and Refinance Agency Ltd. [MUDRA] is a non-banking financial institution to support the development of micro enterprises in the country. The scheme was set up by the government for providing loans up to INR 10 lakh without collaterals to small & micro enterprises engaged in trading, manufacturing, and services sector.

In FY 2022-23, total number of loans sanctioned were 3,17,79,244 with total amount of INR 2,37,192 crore.

II. State Government initiatives

While the Central Government has taken multiple steps to promote a cohesive start-up ecosystem, the state governments have been equally proactive, evident by the number of states with a dedicated start-up policy.

State support is a crucial for the growth of start-ups, along with the Central Government support. With the right nurturing, mentoring and supporting, these can contribute significantly to the growth of the state economy, particularly, through job creation. There is a high potential to promote home-grown solutions and with the right policy interventions, states have much to gain.

In light of the Start-up India Initiative, 31 of the 28 States and 8 Union Territories have a dedicated Start-up Policy. 27 of these Start-up Policies were developed after the launch of the Start-up India initiative in 2016. There is at least one DPIIT-recognized start-up present in each of the 28 States and 8 Union Territories.

Measures such as access to knowledge, mentoring, markets and incubators are some of the many steps that are being witnessed today. A key concern is the restrictive nature of regulatory compliances. To ease them, several states have taken up ease of doing business measures such as a single window portal for assistance with regulatory and other operational issues, permission for self-certification under labour and environmental laws, and for 24*7 operations.

In the same stride, it is essential to examine the state support for the start-up ecosystem, particularly through the grant of financial and non-financial incentives. The eligibility criteria to avail incentives under the respective state policies across selected states and the definition under Central Government Schemes has been compared below.

Particular	DPIIT	Maharashtra	Karnataka	Gujarat	Uttar Pradesh
Eligible entities	Private Limited Company, Partnership and Limited Liability Partnership	Private Limited Company, Partnership and Limited Liability Partnership	-	-	Private Limited Company, Partnership and Limited Liability Partnership
Max. period since incorporation/ registration	10 years	7 – 10 years depending on sector	4 – 7 years depending on sector	10 years	10 years
Max. turnover	INR 100 crore	INR 25 crore	INR 50 crore	INR 100 crore	INR 100 crore
Other conditions	Innovativeness, development or improvement of products or processes or services or, business scalability with employability	Innovativeness, development or improvement of products or processes or services or, business scalability with employability	Technology based Registered in Karnataka 50% qualified workforce from Karnataka	-	Incorporated in Uttar Pradesh and registered with Government of India

In furtherance to the above comparison of the eligibility criteria under central and select state schemes, it can be inferred that this created ambiguity as turnover criteria and maximum period criteria is not uniform across schemes. If the key criteria across schemes are common, then it will enable the investors to optimize the use of the incentives.

A brief summary has been provided of the start-up policies available in Maharashtra, Gujarat, Karnataka and Uttar Pradesh.

A. Maharashtra

Maharashtra is the biggest state economy in India, contributing approximately 15% to the national GDP. The state has gained a spot in the Ministry of Commerce and Industry's Startup Rankings as one of the top performers. It has a robust ecosystem for start-ups with the key sector emerging as food processing.

The Maharashtra State Innovative Start-up Policy 2018 places special emphasis on the promotion of innovative entrepreneurship. The Policy recognises that an enabling environment is the cornerstone to fostering these entrepreneurial ventures and does so, through a holistic view of promoting novel solutions across sectors.

Their approach includes making the regulatory environment more conducive,

bridging the gap between start-up entrepreneurs and industry practitioners, and providing support and assistance, both fiscal and non-fiscal.

Incentives available under the Policy –

Sr. No	Particular	Incentive	Restriction
1	Net SGST reimbursement	Reimbursement in lieu of net SGST paid by the entity	Applicable whenever system credit for the same is not available to the customer of these startups
2	Stamp duty and registration fees compensation	100% compensation for first 3 years, and 50% for the next 3 years	Applicable to recognised incubators and startups
3	Quality testing assistance	Assistance of up to 80% of costs incurred	-
4	Patent filing assistance	Assistance of up to 80% of costs incurred up to INR 2 lakh for Indian patents and INR 10 lakh for international patents	-

Other initiatives –

1. Permission to file self-certifications for select government compliances and relaxation of local law conditions
2. Easing norms for public procurement by start-ups
3. Setting up of innovation clusters, incubators and accelerators and funds to provide early-stage funding
4. Recognition of support towards incubators, accelerators, centres of excellence and start-up park as a corporate social responsibility activity
5. Setting up of the Maharashtra State Innovation Society for registrations, detailed support on funding and public procurement, grievance redressal mechanism and mentorship and incubator support
6. Setting up of the Women Incubation Centre as part of the Women Entrepreneurship Cell to promote women's representation in start-ups.

B. Karnataka

Karnataka is home to Bengaluru that has driven the IT economy. There are over 4,000 registered start-ups in the state. Being dubbed the Silicon Valley of India, there is tremendous potential for fostering innovation and entrepreneurship. In the 2021 Start-up Rankings, it was ranked as one of the 'best performers'.

The Karnataka Start-up Policy 2015 aims to nurture a global start-up ecosystem through strategic investing and policy interventions. The new 2022 Policy has been notified recently and is expected to be made public in the near future. However, to understand the ecosystem, it is imperative to look at the spirit that the 2015 Policy sought to create.

Incentive available under the Policy –

Sr. No	Particular	Incentive	Restriction
1	Net SGST reimbursement	Reimbursement up to a maximum of INR 50 lakh turnover for a period of 3 years	Applicable to incubated startup companies
2	Financial assistance as matching grants	Government of Karnataka's 1:1 basis as matching grants raised by the incubator from the Government of India	-
3	Marketing assistance	Reimbursement of 30% of costs incurred in international marketing up to INR 5 lakh per year per company	-
4	Patent filing cost reimbursement	Reimbursement of cost incurred up to INR 2 lakh for `Indian patents and INR 10 lakh for international patents	-

Other initiatives –

1. Permission to file self-certifications for start-ups in recognised incubators/accelerators under various Acts and Rules
2. New Age Incubation Scheme – Financial assistance to select academic institutions for establishment of incubators and encouragement of student projects, by way of grants, internship stipends and other support programs.
3. Assistance in setting up of technology business incubators in higher learning institutions with well-developed research and development facilities
4. Setting up of a fund to assist in early-stage funding
5. Setting up of Start-up Karnataka as a dedicated helpline, assistance with state-level approvals and clearances, list of incubators and mentors and detailed support on public procurement, funding etc.
6. Relaxation in norms regarding public procurement for start-ups

C. Gujarat

Like Karnataka, Gujarat has also been ranked as one of the 'best performers'

in the 2021 Start-up Rankings. With over 8,000 registered start-ups the state has been very proactive in its regular policy interventions to promote the entrepreneurial spirit in the start-up ecosystem. The state has more than 180 incubation centres. In addition, iCreate (International Centre for Entrepreneurship and Technology) is India's only non-academic institution dedicated to fostering start-ups based on technological innovation into successful businesses.

Recognising the need to provide support to start-ups from their inception, the erstwhile Industrial Policy 2015 was drafted with several incentives being provided. With the shift in the national importance accorded to start-ups post the Start-up India initiative, the new Industrial Policy 2020 was notified to encourage research and development, start innovation and entrepreneurship. The Scheme is sector agnostic.

Incentives can only be claimed under one start-up scheme of the government. However, start-ups/innovators availing benefits under the Student Start-up and Innovation Policy would be eligible to claim incentives under both schemes.

The incentives under this Scheme include –

Sr. No	Particular	Incentive	Restriction
1	Sustenance allowance	INR 20,000 per month per startup for 1 year	-
2	Seed support	Support of INR 30 lakh on cost of raw materials, hardware, testing and trial, marketing,	-
3	Additional financial assistance	Assistance of INR 10 lakh to startups	Applicable to startups having innovative projects which will have a significant impact on society
4	Interest subsidy	Subsidy of up to 9% on term loans	Applicable to startups approved/sanctioned under this Scheme
5	Acceleration program assistance	Assistance of up to INR 3 lakh per startup to enrol and participate in national/international recognised acceleration programs	-
6	Skill development assistance	Reimbursement of up to INR 1 lakh per startup for participation in skill development programmes	Applicable to approved/ sanctioned startups

Other initiatives –

1. Dedicated team in the Industries Commissionerate of Gujarat for the supporting the development of the ecosystem
2. Setting up of the Start-up Gujarat portal as a one-stop solution for registrations, incubators and accelerators, state-level approvals and clearances, list of mentors and a grievance redressal mechanism.
3. Establishment of herSTART, a focused program to enable growth in the number of woman entrepreneurs by the Gujarat University and Start-up Entrepreneurship Council

While incentives are majorly availed through the Industrial Policy, the Gujarat Government has also notified the Gujarat Student Start-up and Innovation Policy (2022-27). This is a unique Policy catering towards nurturing the potential for entrepreneurship and innovation of students across various universities, institutes and colleges. Incentives in the form of IPR support, project support and grants are available under the Policy.

D. Uttar Pradesh

Uttar Pradesh has built up an impressive entrepreneurial ecosystem in the state through its policy interventions and ease of doing business measures. It is India's most populous state with a tremendous potential of innovation at the grassroot level. There are over 3,000 start-ups in the state, with over 800 of them being women-led.

With start-ups being a key concern for the government, the first IT & Start-up Policy 2016 was announced. However, key amendments were brought in the very next year, and the IT and Start-up Policy 2017 came into force. With the focus here being only on the IT sector, the Government sought to cover start-ups across multiple sectors under the umbrella of a single Policy. Thus, the Start-up Policy 2020 was passed, aimed at encouraging innovation within the youth and the development of ideas to action.

The incentives under this Scheme include -

Sr. No	Particular	Incentive	Restriction
1	Capital grant	Reimbursement of 50% up to INR 1.25 crore	Applicable on setting up/ scaling up technology infrastructure for private host institutes
2	Operational expenditure support	Support of up to INR 30 lakh per year for 5 years	Applicable to incubators which have 10 or more startups incubated
3	Acceleration programs	Support of up to INR 5 lakh	Applicable to institutions running acceleration programs with minimum 10 startups participating

Sr. No	Particular	Incentive	Restriction
4	Sustenance allowance	Support of INR 15,000 per month per startup for 1 year	Applicable to 10 startups per incubator per year
5	Seed capital/ marketing assistance	Marketing assistance of up to INR 5 lakh per startup	Applicable to 10 startups per incubator per year
6	Patent filing cost assistance	Reimbursement of up to INR 2 lakh for Indian patents and INR 10 lakh for international patents	-
7	Event participation assistance	Reimbursement of up to INR 50,000 for national events and INR 1 lakh for international events	Applicable to all Government of India registered startups which are incorporated in Uttar Pradesh

Other initiatives –

1. Setting up of the Start-up Uttar Pradesh portal for state level approvals and clearances, registrations, detailed support on funding and public procurement, mentorship support, grievance redressal mechanisms and accelerator programs, amongst others.
2. Preference to start-ups in Government procurement
3. Set up of an UP-Start-up Fund with a budget of INR 1,000 crore
4. Hosting of multiple events like Hackathons, Start-up Mela, Ideathons etc. to promote innovation and entrepreneurship
5. Permission to file self-certifications for various labour and environmental laws and operation of three-shift operations

Despite the progress made so far, Indian businesses face challenges of knowledge and exposure deficiency, and overly time consuming procedures for claiming initiatives. The government, for its part is creating an enabling environment through its flagship Startup India initiative which is straight cashback and other benefits for the startups. Meanwhile the government is promoting outreach and network benefits to Tier 2 and Tier 3 cities, as well as easing financing and tax breaks, the investors should make the maximum use of such entrepreneurial initiatives.

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"Happiness is when what you think, what you say, and what you do are in harmony."

— *Mahatma Gandhi*

CA Ninad Karpe

How to start your angel investing?

There are a staggering 74,400 start-ups registered with the Department For Promotion Of Industry and Internal trade ('DPIIT') and the total universe of start-ups in India is far more. Is there an opportunity to start your journey as an angel investor? Can it become a profitable investment? And how can you get going?

An angel investor is an individual who invests funds in high-risk start-ups. In many start-ups, angel investors are actively involved in mentoring the entrepreneurs, helping them plan and execute their business strategies. Angel investors usually provide early-stage capital to young start-ups at a stage when it is difficult for them to raise funding from financial institutions. They take high risks in return for high returns.

Like every business cycle, the "maturity cycle" seems to be impacting some of the funded start-ups and as this cycle unfolds, the entire start-up ecosystem will benefit. However, there is no slowdown in the flow of early-stage start-ups that are emerging from schools, colleges, and incubators and therein lies an opportunity to become an angel investor. Here are five simple steps to becoming an angel Investor.

Step 1 - Determine your investable wealth or net worth

Before committing to angel investing, you should calculate your net worth to determine how much money you can afford to invest in a start-up. Investing your hard-earned money in a high-risk asset class is never easy. You need to start by allocating a small percentage (5%-10%) of your overall portfolio of assets for investments in start-ups. Unlike other investments, the downside to Angel investing is that it can be binary ie if any of the start-ups fail, you might lose all the money you have invested in the start-up; but if it succeeds, you can sing your way to the bank. Start-up investments are also illiquid and that should also be factored into your decision-making process. A good rule of thumb is to invest only what you cannot afford to lose. Once you have calculated your net worth and allocated an amount that you are comfortable with, the next step is to identify suitable start-ups for investment. Keep in mind that for every 10 start-ups that you invest in, one or two may succeed.

Step 2 - Identify start-ups for investment

Angel investing is a risky business; as such, you need to find the right balance between

risk and potential reward. In this step, you need to do your research to identify the right start-ups for investment. A great way to do this is to follow angel investors on social media channels such as LinkedIn and Facebook. You can also go to networking events and talk to other investors to learn more about the industries that are of interest to them. Once you have identified several companies that seem like a good fit for you, the next step is conducting due diligence on them to determine their viability as an investment opportunity.

Step 3 - Evaluate investment opportunities

The next step is to evaluate each investment opportunity that you have identified to ensure that it is a viable venture. To do this, you need to evaluate the Founder(s), the stage of development of the business, the industry in which it operates, etc. It is also important to get an understanding of the market in which the company operates to identify any opportunities that could be exploited in the future. If the start-up is not a good fit, you can simply move on to the next one on your list. This process may take some time, but it is important to take your time and avoid rushing into an investment decision to avoid making a costly mistake.

Step 4 - Secure your investment

Once you are sure about investing in a particular start-up, you will need to secure your investment by negotiating the terms of the deal with the founders of the company. This may involve working out the valuation of the start-up and the rights granted to you as a shareholder. Once you have agreed to these terms, you are ready to invest in the start-up. Finally, you will need to complete the required paperwork to proceed with the investment and transfer the funds to the bank account of the start-up.

Step 5 - Monitor your investment

The success of your investment will depend on how well you monitor your investments after you have made the deal. You will need to closely monitor the progress of the start-up and ensure that it is moving in the right direction. You will also need to review the financial information of the company regularly to determine whether it is still a good investment. Additionally, you will also need to keep a close eye on the performance of the management team of the company to ensure it performs to your expectations. Monitoring your investment is an important task that requires a lot of work and attention to detail, but it is essential for the long-term success of your investment portfolio.

There are other critical factors in your decision-making of investing in start-ups. What kind of an investor would you like to become? There are a couple of options:

1. **Opportunistic**: You would only invest in start-ups based on current opportunities that currently exist in the market. You would then invest in any exciting start-up investment opportunity that comes your way rather than following a specific strategy.
2. **Thesis driven**: You would invest within certain parameters which you have drawn for yourself.
3. **Sector-driven**: You would only invest in a particular sector or industry in which you have significant expertise or experience. For example, you might decide to limit your investments in the healthcare industry or the fintech sector.
4. **Geographically Driven**: You would invest in companies based in particular regions or countries that you have decided to focus on. Will you invest

only in start-ups registered in India or will you invest in all companies regardless of where in the world they are registered?

5. **Trend-driven**: Will you invest in the latest trends of the day? If so, what trends will you consider? Are you considering investing in artificial intelligence-related companies? Will you invest in start-ups with the latest trends like Web 3, Crypto, Metaverse? Or will you also consider companies that are pursuing more traditional methods?

6. **Stage of the start-up**: Do you want to invest in pre-revenue start-ups? Will you consider investing only in early-stage start-ups? Or, would you prefer to invest in start-ups that have already achieved some revenue? Would you prefer to invest in start-ups that are in the seed round or the Series A round?

With this understanding, and your willingness to invest, you will need to decide the ticket size of each investment. There are two options:

1. **Spray and pray**: where you invest small amounts in a large number of start-ups and hope that some of them will give you hefty returns

2. **Pray and pray:** where you invest bigger ticket amounts in a smaller number of start-ups and track them closely.

In an ideal scenario, you should look at angel investing through the lenses of a portfolio investor and spread your risk over many start-ups, investing over a couple of years. Should any of your early-stage start-ups do well and go to the next round of funding (pre-Series A or Series A), you need to decide if you would want to "double down" your investment and participate in the next round or restrict your investment to your initial amount. Most Venture Capital firms believe in "backing the winners" and doubling down on their investments. But as an angel investor, you could build your thesis on downstream investments in successful start-ups.

And finally, you should take the plunge and start investing. You may start with some "baby steps", but making random investments will limit your success. If you build a proper thesis and invest intelligently, you could be on your way to being a successful angel Investor. Good luck!

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"Don't look back—forward, infinite energy, infinite enthusiasm, infinite daring, and infinite patience—then alone can great deeds be accomplished."

— *Swami Vivekananda*

"The best way to find yourself is to lose yourself in the service of others."

— *Mahatma Gandhi*

Keshav B. Bhujle
Advocate

DIRECT TAXES
Supreme Court

1 ***CIT vs. Mansukh Dyeing and Printing Mills; [2022] 449 ITR 439 (SC): Dated 24/11/2022***

Capital gains — Transfer — Distribution of capital assets on dissolution of firm "or otherwise" — Dissolution of firm not essential ingredient — Revaluation of assets and credit to capital accounts of partners — Is in effect distribution of assets to partners — New partners inducted with small capital contribution immediately acquiring huge credits in capital accounts available for withdrawal — "transfer" falling in category of "otherwise" — Firm liable to capital gains tax: Ss. 2(47)(ii), 45(4), 47(ii) and 50 of ITA 1961: A. Ys. 1993-94, 1994-95

The assessee is a partnership firm. Originally the assessee firm consisted of four partners. On November 1, 1992, the firm was reconstituted and three more partners were admitted. The reconstituted partnership deed mentioned that two partners had decided to withdraw part of their capital. On January 1, 1993, the assets of the firm were revalued and an amount of ₹ 17.34 crores was credited to the accounts of the partners in their profit-sharing ratio. Some of the existing partners withdrew part of their capital which was totally roughly ₹ 20 to ₹ 25 lakhs. Thus, ₹3.12 crores was credited to VS (who had contributed ₹ 4.50 lakhs), ₹ 1.56 crores to BD (who had contributed ₹ 2.25 lakhs), ₹ 1.56 crores to RD (who had contributed ₹ 2.25 lakhs), and ₹ 1.73 crores to RT (who had contributed ₹ 2.50 lakhs). For the A. Ys. 1993-94 and 1994-95, the Assessing Officer took the view that the revaluing of the assets, and subsequently credit to the respective partners' capital accounts constituted a transfer liable to capital gains tax u/s. 45(4) of the Income-tax Act, 1961. As land and building were involved, and the assessee had claimed depreciation on the building, the Assessing Officer assessed the short-term capital gains u/s. 50.

The Commissioner (Appeals) confirmed the addition. The Tribunal deleted the addition observing that revaluation of the assets and credit to the partners' accounts did not involve any transfer. The High Court dismissed the Department's appeals.

The Supreme Court allowed the appeals filed by the Revenue and held as under:

"i) By the omission of sections 2(47)(ii) and 47(ii) of the Income-tax Act, 1961,

transfer by way of distribution of capital assets was removed from the ambit of the definition of "transfer" and was exempt. This helped assessees to avoid the levy of capital gains tax by revaluing the assets and then transferring and distributing them at the time of dissolution. The object and purpose of introduction of section 45(4) was to plug this loophole.

ii) To attract the capital gains tax under sub-section (4) of section 45 as amended by the Finance Act, 1987, with effect from April 1, 1988, what would be required is: transfer of capital asset by way of distribution of capital assets; on account of dissolution of a firm; or other association of persons; or body of individuals; or otherwise. The words "or otherwise" in section 45(4) are very important. In view of the amended section 45(4), by which the expression "or otherwise" is specifically added, the submission that section 45(4) would not be applicable where there is only transfer of the amount on revaluation to the capital accounts of the respective partners of a firm, without a dissolution of the firm, is not sustainable.

iii) The assets of the firm were revalued to increase the value by an amount of ₹ 17.34 crores on January 1, 1993 (relevant to the assessment year 1993-94) and the revalued amount was credited to the accounts of the partners in their profit-sharing ratio and the credit of the assets' revaluation amount to the capital accounts of the partners could be said to be in effect distribution of the assets valued at ₹ 17.34 crores to the partners. During the years, some new partners came to be inducted by introduction of small amounts of capital ranging between ₹ 2.5 and 4.5 lakhs and the newly inducted partners had huge credits to their capital accounts immediately after joining the partnership, which amount was available to the partners for withdrawal and in fact some of the partners withdrew the amount credited in their capital accounts.

iv) Therefore, the assets so revalued and the credit into the capital accounts of the respective partners could be said to be "transfer" and which fell in the category of "otherwise" and therefore, the provisions of section 45(4) inserted by the Finance Act, 1987 with effect from April 1, 1988 would be applicable.

v) In view of the above and for the reasons stated above, the impugned judgment and order passed by the High Court and that of the Income-tax Appellate Tribunal are unsustainable and the same deserve to be quashed and set aside and are accordingly quashed and set aside. The order passed by the Assessing Officer is hereby restored."

2 *Dy. CIT vs. Mastech Technologies Pvt. Ltd.; [2022] 449 ITR 239 (SC): Dated 03/11/2022:*

Reassessment — Notice u/s. 148 — Limitation — Transfer of AO after issue of notice and furnishing assessee with reasons for reopening assessment — Succeeding officer can continue proceedings from that stage — Succeeding officer issuing notice afresh and at request of assessee supplying reasons for reopening — Issue of second notice does not signify dropping of proceedings on first notice — Assessment order passed on basis of first notice — Reopening of assessment valid — High Court setting aside reassessment order

— Not proper — Assessee given liberty to appeal against assessment order: Ss. 129 and 148 of ITA 1961: A. Y. 2008-09

March 23, 2015, the Assessing Officer issued a notice u/s. 148 of the Income-tax Act, 1961 for the A. Y. 2008-09. At the request of the assessee, the Assessing Officer supplied the reasons for reopening. However, thereafter, the Assessing Officer was transferred and the new Assessing Officer who took charge issued another notice u/s. 148 of the Act dated January 18, 2016. Again, at the request of the assessee, the Assessing Officer supplied the reasons for reopening of the assessment. The assessee submitted its objections to the reopening of the assessment. The Assessing Officer rejected the objections of the assessee and thereafter, passed an order of reassessment on March 30, 2016.

On a writ petition filed by the assessee, the Delhi High Court set aside the reopening of the assessment on the grounds that in view of the issuance of the second notice u/s. 148 of the Act dated January 18, 2016, the first notice u/s. 148 dated March 23, 2015 was given up, and the second notice dated January 18, 2016 was barred by limitation, that no reasons were recorded while reopening when the second show-cause notice dated January 18, 2016 was issued and further that the notice dated January 18, 2016 did not specifically mention that it was in continuation of the earlier notice dated March 23, 2015.

The Supreme Court allowed the appeal filed by the Revenue and held as under:

"i) In case of change of the Assessing Officer section 129 of the Act permits the succeeding officer to continue the earlier proceedings from the stage at which they were before the predecessor officer. The fresh show-cause notice dated January 18, 2016 was not warranted or required to be issued by the succeeding Assessing Officer. In that view of the matter, the issuance of notice dated January 18, 2016 could not be said to be tantamount to dropping the earlier show-cause notice dated March 23, 2015. The reasons to reopen the assessment had already been furnished after the first show-cause notice dated March 23, 2015. The finding recorded by the High Court that the subsequent notice dated January 18, 2016 was barred by limitation was unsustainable.

ii) The assessment order was passed on the basis of the first notice dated March 23, 2015 and not on the basis of the notice dated January 18, 2016. Under the circumstances, the High Court erred in quashing and setting aside the reopening of the assessment.

iii) As the assessee did not challenge the assessment order on the merits and the High Court had set aside the assessment order on the ground that initiation of the reassessment was bad in law, the assessee was to be given liberty to file an appeal before the Commissioner (Appeals) within four weeks, subject to compliance with other requirements, and the appeal was to be considered in accordance with law and on its own merits, without raising the issue with respect to limitation. However, the assessee shall not be permitted to reagitate the question of reopening of the assessment."

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Jitendra Singh
Advocate

Radha Halbe
Advocate

Harsh Shah
Advocate

DIRECT TAXES

High Court

1 *PCIT vs. Simon India Ltd [2022] 145 taxmann.com 389 (Delhi)*

Business expenditure - Section 37 of the Income Tax Act, 1961 - loss arising on reinstatement of the forward cover purchase contracts (marked-to-market loss) is an allowable deduction under Section 37(1) of the Income-tax Act, 1961 ('the Act')

The assessee before the Hon'ble Delhi High Court was engaged in the business of providing engineering, consultancy and related services. The assessee, while filing the return of income, claimed a loss of ₹ 9.20 crores against a forward contract entered into to hedge the risk against foreign exchange fluctuations to cover the exports and imports. Out of the total loss, the loss of ₹ 7.12 crores were related to unmatured forward contracts. The Assessing Officer ('AO') while finalising the assessment, disallowed the claim of the assessee on the ground that the loss on forward contracts is speculative and liable to be disallowed in terms of the Central Board of Direct Taxes ('CBDT') Instruction No. 3/2010. On appeal, the First Appellate Authority allowed the claim of the assessee. The department challenged the order of the Learned ('Ld.') Commissioner of Income-tax (Appeals) ['CIT(A)'] before the Hon'ble Appellate Tribunal ('ITAT'). The ITAT held that the CBDT Instruction is not applicable in the present case as the transaction could not be considered as speculative. Thus, loss on forward contracts could not be disallowed in terms of the CBDT Instruction.

The department being aggrieved by the order of the ITAT preferred an appeal before the Hon'ble Delhi High Court under section 260A of the Act. Hon'ble High Court was pleased to upheld the order of the ITAT by observing that undisputedly, the Forward Contracts are hedging transactions. The Court held that the Assessee has reinstated its debits and credits from the underlying transactions on the value of the foreign exchange on the due date. It was held that the corresponding losses/gains under the Forward Contracts, thus, were also required to be accounted for to arrive at the real profits and that it would be anomalous if, on the one hand, debtors and creditors, in respect of current assets, are stated at the current value of foreign exchange and the corresponding loss on the hedging transaction is not accounted for. The Court held that in essence, the Assessee has stated his income by taking into account the foreign exchange value as it stands on the due date. The Court observed that it is well settled that

the CBDT Instructions and circulars which are contrary to law are not binding. Thus, loss on account of Forward Contracts, cannot be considered speculative and the AO had erred in disallowing the same.

2 *Auroglobal Comtrade (P.) Ltd. vs. CBDT [2022] 143 taxmann.com 120 (Orissa)*

Reassessment - Section 148 of the Income Tax Act, 1961 - once assessee participated in the reassessment proceedings by filing the return in response of the notice issued under section 148 - subsequently assessee challenging the said notice on the ground of absence of reasons with material particulars for proposed reassessment - unjustified

The assessee before the Hon'ble Orissa High Court has originally filed its return of income on 26.09.2018 under section 139(1) of the Act. The return filed by the assessee was processed under section 143(1) of the Act on 14.04.2019. Subsequently, the AO issued a show cause notice dated 15.03.2022 under section 148A(b) by observing that the assessee has suppressed its income by showing bogus purchases. The assessee neither responded to said notice nor requested for an extended time to respond to the notice. The AO, in view of the failure of the assessee to respond to the above notice, concluded that income chargeable to tax in the case of the assessee escaped assessment. The AO initiated the reassessment proceedings by passing the order under section 148A(d) and notice under section 148 of the Act dated 26.03.2022. The assessee responded to the notice issued under section 148 of the Act by filing its return of income on 23.04.2022. After having participated in the proceeding, the assessee filed an application/reply on 18.05.2022 pursuant to notice dated 15.03.2022 issued under section 148A(b) of Act requesting the AO to refrain from proceeding with reassessment.

The assessee being aggrieved by the action of the AO in initiating the reassessment proceeding challenged the reopening notice, before the Hon'ble Orissa High Court, on the ground that its application dated 18.05.2022 which was submitted in response to the order under section 148A(d) was not considered. Hence, the AO had no reasons backed by material particulars that income had escaped assessment and the assessee was unaware of the evidence based on which the proceeding for assessment under section 148 of the Act is initiated.

Hon'ble High Court has declined to interfere with the reassessment proceedings by observing that the fact that the assessee never approached the AO for extension of time. The AO provided sufficient time to the assessee to respond and finally proceeded on 26.03.2022 by recording the reason to initiate the proceeding under section 148 of the Act. Once any quasi-judicial function is commenced by the issue of notice under section 148, the same is subject to the limitation contained in section 149 of the Act and there is no scope for any reset. Further, having filed revised returns for the assessment year 2018-19 after receiving the notice dated 26.03.2022 under section 148, the assessee is said to have participated in the proceeding and surrendered to the jurisdiction of the AO who was competent to initiate the proceeding under section 148 of the Act. It was held that the assessee would be rendering violence to provisions of section 148 by acceding to this contention since a person cannot take advantage of its own wrongs.

3 ***Suman Jeet Agarwal vs. ITO [2022] 143 taxmann.com 11 (Delhi)***

Time limit for issuance of notice under section 148 - Section 149 of the Income Tax Act, 1961 - mere generation of notice under section 148 on ITBA software cannot in fact or in law constitute issue of notice, it is only upon due dispatch, that notice can be said to have been 'issued' - date and time of dispatch as recorded in ITBA portal will be taken as date of issuance of notice - if dispatch of notice by post and e-mail was carried out on or after 01.04.2021, it was to be held that the impugned notices dated 31.03.2021 would not meet test of 'issued' under section 149 of the Act

Facts

In the case of the assessee, the notices under section 148 of the Act were generated and sent for dispatch through electronic mail ('e-mail') by the Jurisdictional Assessing Officer ('JAO') using the Income-tax Business Application ('ITBA') software developed by the Tata Consultancy Services ('TCS') for the Department. The facts available on record showed that the impugned notice was generated by JAO using the ITBA software on 31st March, 2021, however, the same was dispatched through the ITBA's e-mail system, using the ITBA servers on or after 1st April, 2021; and/or dispatched by JAO through normal post on or after 1st April, 2021.

The assessee has challenged the validity of the impugned notice issued under section 148 of the Act prior to its amendment on 01.04.2021 vide Finance Act, 2021.

Assessee's argument

The assessee before the Hon'ble High Court has contended that the expression 'issued' has been judicially interpreted by the Courts as framing the order and taking necessary action to dispatch the same. Therefore, the mere generation of a Notice on the ITBA portal does not satisfy the test of 'issue' without proving that the same has been dispatched within the time-barring period. The assessee further argued that the mere generation of a notice on the ITBA Screen and signing the same is not sufficient for satisfying the test of 'issued' and it is only when the Notice has been dispatched in terms of section 13 of the Act of 2000, would the same be declared to be issued.

Department's contention

Department argued before the Hon'ble High Court that for the purpose of determining the date on which the impugned Notices have been 'issued' within the meaning of section 149 of the Act, the date of dispatch by ITBA software system through e-mail or speed post is not relevant and it is only the date of generation of the impugned Notices on the ITBA portal, which must be considered. Thus, it was argued that the date of receipt of the impugned Notice by the petitioner is not the criterion for determining whether the impugned Notices have been 'issued' within the time limit prescribed under section 149 of the Act.

Held

Hon'ble High Court has held that it is a settled position of law that the notice under section 148 of the Act must be served in accordance with the procedure established by law, to the correct addressee, otherwise, the reassessment proceedings would be invalid in law. The issuance of an e-mail attaching an electronic notice to an unrelated e-mail address does not constitute as due dispatch and therefore, the Notices cannot be said to have been issued on 31st March, 2021. Hon'ble High Court has further held that as an authenticated copy of the notice was placed on the registered account of the assessee on the E-filing portal,

the said notice will be held to have been issued on the date on which the Notices were first viewed by the assessee on his E-filing portal.

4 ***Devendra Babulal Jain vs. ITO [R/ SPECIAL CIVIL APPLICATION NO. 12961 of 2019, dated 16.12.2022] (Gujarat High Court)***

Collection and recovery - Section 226 of the Income Tax Act, 1961 - liability of directors in the private limited company - appeal against assessment order pending for adjudication - company has not deposited 20 per cent of outstanding demand to get stay from the appellate authority - AO is unjustified in directly initiating recovery proceeding against the directors of the company without taking an assertive step for recovery of the outstanding tax dues from the private limited company. [Section 179]

The assessee before the Hon'ble Gujarat High Court is an Individual and one of the Directors of Nakoda Syntex Private Limited. The AO passed the assessment order under section 143(3) of the Act in respect of the said company, making an addition of Rs.7cr. on account of bogus unsecured loans. Being aggrieved by the said assessment order, the aforesaid company preferred an appeal before the Ld. CIT(A). The AO issued a recovery notice demanding payment of the outstanding dues from the said company. Pursuant to such recovery notice, the said company filed a stay application before the AO appraising about the appeal filed by the said company. The AO rejected the stay petition of the said company without affording any opportunity of hearing to the said company. The AO initiated the proceedings under section 179 upon the director of the company and passed the impugned order under section 179. He also issued a certificate under section 222 of the Act and notice of demand calling upon the director to pay the outstanding dues of the company within 15 days of receipt of notice. Being aggrieved by the impugned action of the AO, the assessee has preferred the present petition.

Hon'ble Gujarat High Court was pleased to allow the writ petition of the assessee, setting aside the proceedings initiated under section 179 of the Act by observing that:

- The AO has failed to take any action for recovery of the outstanding dues except issuing notice for recovery and attaching the bank account of the private limited company.
- The AO ought to make efforts for recovery of the outstanding dues from the private limited company which had committed default in payment of the outstanding demand.
- The assessee had prima facie shown that non-recovery cannot be attributed to any gross negligence, misfeasance or breach of duty as director of the private limited company.
- In the impugned order, the AO failed to consider the fact that the assessee had tendered his explanation and contended that the director had challenged the order of assessment before the appellate authority and the director had not remained negligent nor there was no misfeasance or breach of trust on part of the director.
- Only because the director was unable to deposit 20% of the demand raised in the assessment order against the company, he cannot be said to be negligent and AO cannot therefore invoke jurisdiction under section 179 of the Act.

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Neelam Jadhav
Advocate

Tanmay Phadke
Advocate

DIRECT TAXES

Tribunal

1 ***DCIT vs. Sri Sai Lakshmi Industries Pvt. Ltd., ITA No. 1624/Mum/2021 A.Y: 2007-08***

Section: 2(47)(v) – Capital Gain – When the possession of land is not handed over to the developer in part performance of the contract but only a licence is granted to the developer to develop the project, transfer u/s. 2(47)(v) does not take place

Facts

The Assessee entered into a Joint Development Agreement (JDA) with the developer and registered the same in the AY 2014-15. The assessee was a landowner and agreed for the revenue sharing model. Though the licence was given to the developer to develop the property, the agreement contained certain clauses mentioning no transfer/delivery of possession by the assessee to the developer. During assessment, the AO invoked section 2(47)(v) and computed capital gains. Being aggrieved, the Assessee filed an appeal before the CIT(A) and succeeded. The revenue filed an appeal before the ITAT. After hearing both the parties, the ITAT held as under:

Held

The ITAT carefully perused the clauses of the agreement and observed that the Developer took possession of the property for the specific purpose of development only, that too after satisfying the conditions like obtaining approvals, etc. The ITAT also observed that the clause in the agreement specifically mentioned that the possession given to the developer cannot be regarded as delivery of possession in part performance of Agreement for Sale as contemplated under section 53-A of the Transfer of Property Act. The ITAT referred to the decision of the SC in the case of "***ITO vs. Balbir Singh Maini (2017) 398 ITR 531 (SC)*** and the decision of the coordinate bench in ***Dr. Krishna Prasad Mikkilineni vs. DCIT ITA No.929/Bang/2018***. The ITAT finally concluded that the Assessee handed over only a permissive possession and not a legal position without resulting in any transfer u/s. 2(47) of the Act. The ITAT dismissed the appeal of the revenue and allowed in favour of the assessee.

2 *M/s. Natma Securities Limited vs. ACIT - I.T.A. No. 6104/DEL/2019, A.Y 2012-13*

Section 201: Date of presentation of the cheque is the date of payment and interest u/s 201 of the Act cannot be levied when the cheque is handed over to the bank but the bank fails to debit the account on the same day due to its mistake and debits it subsequently

Facts

The Assessee Company is a Non-Banking Finance Company (NBFC). During the FY 2012-13, the assessee deposited TDS amount on 31.07.2013 for ₹ 3,39,98,973/- which included an amount of ₹ 23,72,020/- on account of interest for 5 months starting from 01.03.2013 to 31.07.2013. A demand u/s 201/201(1A) was generated by the CPC. It was the case of the assessee that though the funds were made available to the bank towards payment of TDS, the bank failed to deposit it on the same day and made the payment subsequently on 01.08.2013. The Assessee's submission was that it could not be penalised for the mistake/negligence attributable to the bank. The assessee filed a rectification application u/s 154 of the Act which was rejected. Against it, the assessee filed an appeal before the CIT(A) but failed. Thereafter, an appeal was filed before the ITAT.

Held

The ITAT referred to the judgement of the Coordinate bench in the case of Standard Chartered Bank vs. DCIT ITA No. 2153 to 2156/Mum/2018. It was observed by the ITAT that there was only one day delay in debiting the amount from the Assesses bank account which was a mistake of the banker. The ITAT concluded that the payment of TDS by the assessee would relate back to the date of presentation of the cheque i.e. on 31.07.2013 by the assessee to the banker and allowed the appeal of the Assessee.

3 *Dy. CIT vs. Smt. Anju Saraf, ITA No. 436/Nag/2016, (Nag)(Trib.) (AY 2010-2011)*

Section 23: Income from House Property - Annual value (Computation of) – flat was not habitable on date of sale deed and there were further improvements in the property. Completion certificate issued by architect before the completion of work, No Annual letting value (ALV) could be determined in such circumstances under section 23(1)(a) for year. (r.w.s. 22)

Facts

The AO found that the assessee has failed to offer annual value as per Section 22 on the property which is other than the self-occupied property. According to the AO, the property was purchased vide Sale Deed dated 26-6-2009 and therefore held that the annual value of the property u/s. 22 shall have to be determined for the period for which the property was occupied. This was disputed by the assessee before the Commissioner of Income Tax (Appeals) by placing on record the evidence relating to the completion of property and its occupancy. The Commissioner (Appeals) examined the evidence available on record and found that the property was not fit for habitation on the date of Sale Deed. There were further improvements in the property and it was completed on 30-9-2010. Considering the same, the CIT (A) held that there should not be no notional ALV computed on the property under section 23(1)(a). The Revenue filed an appeal before the ITAT against the view taken by the CIT(A).

Held

The ITAT observed that, the certificate dated 12-08-2010 issued by the Architect for the completion of work, that the construction work of kitchen, bathroom, furniture, electric fittings and other interior work was carried out and they completed the interior work on 9th June, 2010. Thus the claim of the appellant that the property was not fit for habitation on the date of Sale Deed appears to be correct. Considering the architect certificate and in absence of any contrary evidence, the ITAT held that, the claim of the assessee that the property was occupied on 30-9-2010 is accepted and hence No. ALV can be determined in such circumstances u/s. 23(l)(a) of the Income-tax Act for the year under consideration.

4

Sujan Azad Parikh vs. Dy. CIT, ITA NO. 186/Mum/2021 (Mumbai)(Trib.) A.Y: 2007-08

Section: 2(47) – Capital Gain – Sale/Transfer of shares under family agreement as per the direction of CLB (Company Law Board), no capital gain tax was liable to be paid on such transactions

Facts

The Assessee along with other family members was holding shares in a company NPIL under one family business. Due to dispute in functioning of company NPIL and other group concerns, and in order to keep the peace and harmony in family, all family members agreed to family arrangement by filing petition before the Company Law Board (CLB). As per the direction of CLB, the assessee transferred shares of NPIL to another group company under a buy back agreement. The assessee in her return of income claimed that LTCG arose from sale of shares was not taxable. The AO rejected the claim and observed that the transaction of selling of shares of the NPCL by the assessee could not be termed as family arrangement and the same was in the nature of exit of the large stakeholder from the company which was taxable as LTCG. The CIT (A) also confirmed the view of the AO.

Held

While deciding the issue the ITAT observed that, the assessee was one of the family members of the Parikh Group and the above group has two divergent groups identified as SAP Group and ANP Group represented by the respective family heads. The Assessee being the family head, representing the SAP Group. Due to dispute in the functioning of the company NPIL and other group concerns, in order to restore the peace and harmony in the family, all have agreed to family arrangements by filing petition before CLB. It is a fact on record that based on the directions of the CLB and their resolutions, the assessee, representing the SAP Group, agreed to transfer the shares either to ANP Group or to the company itself. The assessee has transferred the shares only on the direction of the CLB. As per the direction of CLB, the assessee had to either transfer the shares to ANP Group or to the company whichever is acceptable to the ANP Group. As far as the assessee is concerned, he has agreed to transfer the shares and it is irrelevant for him how or to whom the shares are being ultimately transferred, as long as he receives the compensation as set out by the CLB. The ANP Group has decided to buy back the shares in the NPIL itself. Therefore, the ITAT held that it is not proper to tax the said transfer of shares in pursuance of a family arrangement approved by the CLB.

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Dr. Sunil Moti Lala
Advocate

INTERNATIONAL TAXATION
Case Law Update

A. HIGH COURT

1 *CIT vs. M/s Nokia Solutions and Networks - [TS-960- HC - 2022 (Delhi)]*

For computing profits attributable to the Indian PE of the assessee, net profit margins of the foreign assessee were to be applied and if resultant figures resulted in losses then no profit/income would be attributable to PE

Facts

i) The assessee was a company incorporated in Finland and was engaged in the manufacture and supply of telecom equipment to Indian telecom operators. The assessee had an Indian AE, NSNIPL which was engaged in rendering installation and commissioning services in relation to the telecom network equipment supplied by the assessee. The assessee claimed that its income from the supply of equipment to Indian telecom operators would not be taxable in India as the assessee did not have a PE in India.

ii) During relevant assessment years, the assessee made payments to Indian AE on account of provision for software services.

iii) The Assessing Officer held that the assessee had a DAPE in India on the ground that the Indian AE was involved in market survey, market research, consumer survey, marketing promotion, after-sale services and warranty services which created mutual goodwill for each other and dependency on each other. Furthermore, the engagement of the assessee and Indian AE was end to end which included pre-bid discussions, bid discussions,conclusion of the contract, capturing requirements of the client, design as per requirements of the client, supply of equipment and installation and commissioning of equipment.

iv) The Hon'ble Tribunal held that on a plain reading of Article 7(1) of the DTAA, the question of attributing profits to the P.E. would arise only if the foreign enterprise is making a profit. This is the condition precedent. If it is making a loss then no question arises at all of attributing any profit to the P.E., which would be taxable in India

v) It noted that the Assessing Officer had taken the gross profit margins of the assessee company for 2009 and 2010 as per its audited accounts instead

of the net profit margins. The gross profits margins of the assessee company for 2009 and 2010 were positive, and that was how the Assessing Officer could attribute profits to the P.E. In so adopting the gross profit margins of the assessee company, the Assessing Officer has acted in a manner which was directly contrary to article 7(1) of the DTAA. It is the Net Profits margins which are to be considered for attribution as per the DTAA.

vi) It held that the computation made by the Assessing Officer in his assessment order was incorrect as the Assessing Officer had not allowed the payments made by the assessee to NSNIPL for the services rendered by NSNIPL as a deduction from the profit attributable to the alleged PE. If the said payments were allowed as a deduction from the gross profit figures taken by the Assessing Officer then again the resultant figure would be losses. Consequently, even if the method of attribution adopted by the Assessing Officer was considered to be correct, in any event, there would be no profit/ income attributable to the PE.

vii) Consequently, the Hon'ble Tribunal by following its own order in ***Nokia Corporation (Formerly Nokia Networks Oy.) vs. Asst. DIT(IT) [2007] 17 SOT 25/112 TTJ627 (Delhi),*** concluded that even if the assessee had a P.E. in India, no profit or income could in law at all be attributed to the P.E. which would be taxable in India.

viii) Aggrieved, the Revenue filed an appeal before the Hon'ble Delhi High Court.

Decision

i) The Hon'ble Delhi High Court noted that Article 7 of the India-Finland DTAA clarifies that the issue of taxability of Assessee would arise only if profits accrue to the Assessee and that too only to the extent they can be attributed to its PE in India.

ii) The Hon'ble Delhi High Court dismissed Revenue's appeal as devoid of substantial questions of law upholding the Hon'ble Tribunal order holding that no profit could be attributed to the Assessee even if it had a PE in India since the Assessee had recorded a net loss at the global level.

Note - Revenue conceded that two out of four proposed questions i.e. whether i) Research & Development activities carried on by NSNIPL constituted a PE and (ii) software supplies could be taxed as royalty was covered in Assessee's favour by i) coordinate bench ruling in the case of Adobe Systems Inc. [W.P (C) 2384/2016 dated 16.05.2016] ii) the Hon'ble Supreme Court ruling in the case of ***Engineering Analysis [(2022) 3 SCC 321]*** respectively.

B. TRIBUNAL

2 ***DCIT vs. Reliance Industrial Holdings (P.) Ltd, [(2022) 144 taxmann.com 180 (Mum- Tribunal]***

A director who holds no share in the company cannot be treated as Associated Enterprise u/s 92A(j) merely because he is described as KMP in its audited accounts since he cannot be regarded as controlling the company merely by reason of being its director and being described as 'Key Managerial Person' in audited annual accounts. [AY 2008-09 and AY 2010-11]

Facts

i) Information was received by the Assessing Officer from the investigation

wing that the Assessee Company had given a guarantee to the ICICI Bank, Singapore in respect of the loan given to Biomatrix Marketing Pvt Ltd. ('Biomatrix'). The AO while recording the reasons for re-opening the assessment, formed the view that the assessee and Biomatrix, on whose behalf the guarantee was said to be given by the assessee, were associated enterprises and that the ALP adjustment in respect of the above transaction has escaped assessment.

ii) The reasons for coming to such a conclusion were as under:

a) The assessee company had provided a bank guarantee to ICICI Bank, Singapore, for sanctioning loan to M/s Biomatrix.

b) The relationship between the assessee company and M/s Biomatrix was examined and the books of accounts of the assessee revealed that Mr Sandeep Tandon (deceased) who was the director in the assessee company was also a 91% shareholder in M/s Biomatrix at the time of the deal.

c) Further, as per para 10 of the Notes and Accounts of the Audit Report of the financial year 2008-09 of the assessee, Mr Sandeep Tandon was shown as the "Key Managerial Person" ('KMP').

d) Section 92A(2)(j) of the Income-tax Act, 1961, relating to the provision of Transfer Pricing provides:-

"92A(2) for the purpose of sub-section (1) two enterprises shall be deemed to be associated enterprises if, at any time during the previous year (j) "Where one enterprise is controlled by an individual, the other enterprise is also controlled by such individual or his relative or jointly by such individual and relative of such individual;"

e) Accordingly, it was evident that Mr Sandeep Tandon was a person controlling the affairs of both the assessee company and M/s Biomatrix Ltd and hence the assessee and M/s Biomatrix were Associated Enterprises within the ambit of Section 92A(2)(j).

iii) Hence, the assessment was re-opened and the assessment was made after an ALP adjustment in respect of the corporate guarantee extended by the assessee to ICICI Bank Singapore in respect of Biomatrix.

iv) Aggrieved, the assessee carried the matter in appeal before the CIT(A), and even though the assessee had succeeded on other grounds, there was no adjudication on the ground w.r.t reasons for re-opening the assessment as the same was treated as infructuous.

v) The assessee was not satisfied despite the relief given to the assessee by CIT(A) and filed a cross objection before the Hon'ble Tribunal.

Decision

i) The Hon'ble Tribunal held that in the case of reopened assessments first and foremost one has to see the reasons recorded for reopening the assessment, as these were the reasons which gave jurisdiction to the Assessing Officer for initiating and proceeding with

the reassessment and the reasons so recorded must meet the judicial scrutiny.

ii) It relied on the judgement of the Hon'ble Bombay High Court in the case of ***Hindustan Lever Ltd. vs. R.B. Wadkar [(2004) 268 ITR 332 (Bom)]***, and held that it was well settled in law that reasons, as recorded for reopening the reassessment, were to be examined on a standalone basis. Nothing could be added to the reasons so recorded, nor anything could be deleted from the reasons so recorded.

iii) It further added that even though the reasons, as recorded, might not necessarily prove escapement of income at the stage of recording the reasons, such reasons must at least point out to an income escaping assessment and not a mere need for an inquiry which might result in detection of an income escaping the assessment.

iv) It noted that the only basis recorded in the reasons for re-opening the assessment was for the assessee being treated as the associated enterprise of Biomatrix (wherein Mr. Sandeep Tandon held 91% equity and who was also a Director in the assessee company) was that as per para 10 of the Notes and Accounts of the Audit Report of the financial year 2008-09 of the assessee, Mr Sandeep Tandon was shown as the "Key Managerial Person" (and that consequent ALP adjustment had escaped assessment.)

v) It added that just because someone was described as a KMP in the annual accounts and was a director of the company, it cannot be said that, "enterprise is controlled by an individual" as was the necessary precondition for invoking Section 92A(2)(j).

vi) It further added that in order to be said to be in control of another company, as stated in section 92A(2)(b) and (f), either such person should hold more than 26% of the voting power of the company or such person appoints more than half of the directors or members of the governing board or one or more of the executive directors or members of the governing board. Clearly, the connotations of 'control' in the scheme of Section 92A(2) were far more cogent than visualized by a simplistic notion of KMP.

vii) It held that it was futile to even suggest that a person can be said to be in control of a company merely because he was a director of the company, or he was described as a 'KMP' of the said company in its own choice of words in the annual accounts.

viii) It held that nothing recorded in the reasons for re-opening even remotely suggested that this person had more than 26% voting rights, or even significant voting rights, in the company, that person had the right to nominate less than half the board of directors, or one or more executive directors or the members of the governing body, or that there was anything cogent to signify control over the company.

ix) The Hon'ble Tribunal thus concluded that the reasons recorded by the Assessing Officer did not lead to the conclusion that the assessee and Biomatrix were associated enterprises, and, therefore, it could not be said that any income, on account of ALP

adjustment, had escaped assessment and accordingly, quashed the reassessment proceedings.

3 *Sonakshi Sinha vs. CIT [(2022) 142 taxmann.com 414 (Mumbai- Trib.)]*

Foreign Tax Credit could not be disallowed where the assessee had filed Form No. 67 before the completion of the assessment even though the same was not in accordance with Rule 128(a) of the Income-tax Rules (pre-amended) which required the same to be filed on or before the due date of filing of ITR u/s 139(1). [AY 2018-19]

Facts

i) The assessee, an individual and an actor by profession provides services for the promotion and marketing of brands of goods, services, and events. For the year under consideration, the assessee filed its Return of income declaring a total income of ₹ 18,53,90,330. Further, the case was selected for scrutiny under the limited scrutiny criteria for the issue of double taxation relief u/s 90/91 of the Income-tax Act, 1961 ('Act'). The requisite notice u/s 143(2) of the Act was issued

ii) The learned AO had found that the assessee had claimed a foreign tax credit amounting to ₹ 29,21,327. However, from the filing portal, it was observed that the assessee had uploaded form No 67 for claiming foreign tax credit on January 20, 2020, whereas Assessee had filed her Return of Income on September 22, 2018, which was within the due date as per provisions of Section 139(1) of the act.

iii) The AO was of the opinion that the assessee had failed to comply with the letter and spirit of Rule 128(9) of the Income-tax Rules, 1962 ('Rules') which says that form number 67 was required to be filed for claiming foreign tax credit on or before the date of filing of the return. Further, AO also noted that the assessee uploaded Forn 67 after being served with 2 notices of assessment. Thus, the AO disallowed the foreign tax credit claimed by the assessee.

iv) The assessee filed an appeal before National Faceless Assessment Centre ('NFAC'). The assessee claimed before the NFAC that filing form number 67 was a procedural requirement and not a mandatory requirement for claiming the foreign tax credit. Merely because form number 67 was not filed within the due date prescribed in Section 139 (1) of the act but during the course of assessment proceedings, the assessee should not be denied credit for foreign taxes paid. The Assessee further relied on the judgment of Brinda Ramakrishna versus Income Tax Officer 5(3)(1) Bangalore (2021) ITA No. 454/bang/2021 dated 17/11/2021, along with several other decisions which stated that rule 128 being merely a procedural provision, any default in its compliance should not result in disallowance of the credit eligible to be allowed and claimed.

v) However, the CIT(A) rejected the claim of the assessee that the filing of the form at any time would make the rule absurd and also mentioned that all the beneficial provisions should be interpreted strictly as was held by Honourable Supreme Court in ***Ramnath & Co. vs. CIT [116 taxmann.com 885].*** Thus, the appeal of the Assessee was dismissed.

vi) Aggrieved, the assessee filed an appeal before the Hon'ble Tribunal.

Decision

i) The Hon'ble Tribunal after considering the facts of the case noted that the co-ordinate bench in the case of 42 ***Hertz Software India (P.) Ltd vs. ACIT [2022] 139 taxmann.com 448 (Bangalore - Trib.)*** relied on its earlier decision in the case of ***Ms. Brinda Rama Krishna vs. ITO [2022] 135 taxmann.com 358 (Bang - Trib)*** wherein it was held that "one of the requirements of Rule 128 for claiming FTC is that Form 67 is to be submitted by assessee before the filing of the returns and that this requirement cannot be treated as mandatory, rather it is a directory in nature. This is because Rule 128(9) does not provide for disallowance of FTC in case of delay in filing Form No. 67. Further, the Hon'ble Tribunal noted that the same view was taken by a coordinate division bench in ***Vinodkumar Lakshmipathi vs. CIT(A) NFAC ITA No.680/Bang/2022 dated 06.09.2022.***

ii) It held that it was well settled that while laying down a particular procedure, if no negative or adverse consequences were contemplated for non-adherence to such procedure, the relevant provision was normally not taken to be mandatory and it was considered to be purely directory and that admittedly Rule 128 did not prescribe denial of credit of FTC.

iii) It further added that the Act i.e. section 90 or 91 also did not prescribe a timeline for filing such declaration on or before the due date of filing of ROI. It also added that Rule 128(4) clearly mentioned the situations in which the claim of FTC would not be allowed whereas Rule 128(9) does not say that if the prescribed form would not be filed on or before the due date of filing of the return no such credit would be allowed.

iv) It further noted that by the amendment to the rule with effect from 1 April 2022, the assessee could file such form number 67 on or before the end of the assessment year. Therefore, the legislature in its own wisdom had extended such a date which is beyond the due date of filing of the return of income.

v) It distinguished the case of the assessee with the issue involved in the decision of the Hon'ble Supreme Court in the case of Wipro Ltd by saying that here it was not the case of violation of any of the provisions of the Act but of the rule, which did not provide for any consequence, if not complied with.

vi) Thus, the Hon'ble Tribunal concluded that foreign tax credit should be granted to the assessee after filing Form 67, even if it has filed the same after the due date of filing the Return of Income.

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"Truth can be stated in a thousand different ways, yet each one can be true."

— *Swami Vivekananda*

CS Makarand Joshi

CORPORATE LAWS
Case Law Update

Securities And Exchange Board of India (SEBI) Order In The Matter Of Geodesic Limited, dated 19th December 2022

Facts of the case

- SEBI had received a letter from the Company Registrar of the Bombay High Court, along with a copy of the order dated December 22, 2015, in the matter of ***HDFC Bank Ltd. vs. Geodesic Limited.***

- In the said order, SEBI as well as the Enforcement Directorate were directed to take immediate action against the Directors of Geodesic Limited ("the Company") as well as one Shri Dinesh Jajodia, under the appropriate provisions of law, including attachment of their properties as permissible in law.

- The Company in question was incorporated in the year 1982 and was in the business of providing products and solutions for Content, Communication, Collaboration and Electronic Computing etc. At the time of investigation, the company was under liquidation and had 5 subsidiaries.

- There were 5 directors at that relevant time in the Company, who are as follows:

  1. Kiran Kulkarni, Managing Director (Noticee no.3),
  2. Pankaj Kumar, Chairman/Director (Noticee no. 1),
  3. Prashant Mulekar, Director & Compliance Officer (Noticee no. 2),
  4. Vinod Sethi, Independent Non-Executive Director (resigned on May 16, 2013) (Noticee no. 4),
  5. Nitin Potdar, Independent Non-Executive Director (resigned on December 4, 2012) (Noticee no. 5).

- Based on certain complaints received from various stakeholders, SEBI had already initiated an investigation into the books of accounts of the Company to ascertain the possible violations of the SEBI Act, 1992 and regulations made thereunder, and to find out the veracity of the alleged irregularities in the books and accounts of the Company. The investigation was conducted for the

period of April 01, 2011, to March 31, 2012.

- Further, in pursuance of the said investigation, a Forensic Auditor had been appointed by SEBI for conducting a Forensic Audit and examining the books of accounts of the Company. Resultantly, a Forensic Audit Report was filed with SEBI.
- The Forensic Audit Report made the following observations:
  - — The revenues booked and the profits purported to have been generated by the Company were false and non-existent, and thus the Company was misleading and misrepresenting the facts about the actual status of its affairs.
  - — The company had raised funds from overseas investors during January 2008 by issuing FCCB bonds for USD 125 Million, redemption due date for which was January 18, 2013. Subsequently, the company failed to redeem the bonds on the due date. The company along with one of the main overseas subsidiaries, GTSL, were ordered for liquidation by the Bombay High court.
  - — The FCCB bonds were to be used only for overseas acquisitions and investments in joint ventures/ wholly owned subsidiaries and or for any other purpose as permitted by the RBI. However, it was discovered that funds were actually diverted by giving loans to various other entities, thus violating RBI norms.
  - — While the assets which were in the form of investments as per the audited balance sheets were confirmed to be available, however after further probing into the investments statements, mail communications of directors, the beneficiary owner Mr. Dinesh Jajodia (the alleged tax consultant of the Company) and the banker it was revealed that the investments were actually diluted and diverted into other investments.
  - — Further, the monies were invested or given as loans to companies in which Mr. Dinesh Jajodia was personally interested as director.
  - — Additionally, the investigative audit of the books of accounts for the availability of the reserves created by the company, debtors and creditors for realisation revealed that the same were non-realisable as they all were shell companies and outstanding amounts against these companies were generated by bogus entries.
  - — With respect to the Audited Balance Sheets of the Company, it was revealed that the forensic audit of the books of accounts for the past three years was examined in detail, and the status of sales, purchases, returns, reserves and surpluses were found to be non-existent.
- Pursuant to the investigation, a common Show Cause Notice (“SCN”) was issued to the Noticees alleging that:

a) The Audited Balance Sheet of the Company for the Financial Year 2011-12 failed to provide a true and fair view of the status of the affairs of the Company on the

existence of its investments, profits, and reserves.

b) Noticee Nos. 1 and 3, being signatories to the Annual Report of the Company that contained manipulated financials, had misled the investors by not providing a true and fair picture of its quarterly and yearly financials.

c) Noticee nos. 2, 4 and 5, who were the members of the Audit Committee of the Company, had failed to oversee the correctness of the financial statements, which were false and misleading, and by accepting the same they have failed to discharge their duties as members of the Audit Committee.

d) The Noticees engaged in manipulation of the books of accounts for the Financial Year 2011-12 by publishing the same in the Annual Report of the Company, which was not true, by planting false/misleading news about its financials, thus misleading the investors by not providing a true and fair view of its quarterly and yearly financials.

- Additionally, in another related investigation conducted by SEBI in 2020, a Supplementary SCN was served upon Noticee nos. 1, 3, 4 and 5.

Issues

One of the primary issues discussed was whether the Noticee nos. 4 & 5 (Independent Directors), had failed to oversee the correctness of the financial statements for the FY 2011-12 which were found to contain false and misleading figures and amounts and thereby had failed to discharge their duties as Independent Directors?

Rules Applicable

The Noticees were alleged to have violated the following provisions:

- Section 12A(a), (b), (c) of the SEBI Act, 1992

- Regulations 3(b), (c), (d) and 4(1), 4(2)(f), (k) and (r) of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 ("PFUTP Regulations").

Arguments on behalf of Independent Directors

- No specific role had been attributed and only sweeping allegations were made. Therefore, the allegations of fraud were not sustainable. Further, the charges of failure to oversee the financial statements ran contradictory to the charges of having committed fraud. In order to prove the charges of "fraud", some kind of element of "inducement" must be shown, which was lacking in the present case.

- Being Independent Directors, the Noticees were not responsible for the day-to-day affairs of the Company and had insight only through Board processes.

- In order to pin liability on Independent Directors, it needs to be indicated that being Independent Directors, the said Noticees participated in fraud or fraud that took place with their connivance/ consent or that the said Noticees failed to act with diligence, despite having knowledge of fraud through Board processes. Such standards have also been codified under SEBI (LODR) Regulations, 2015 as well as under various Circulars of the Ministry of Corporate Affairs.

- Reliance was placed on an MCA Circular dated July 29, 2011, and an MCA letter dated November 09, 2016, to support the contention that Independent Directors shall not be made liable for a violation which occurred without their knowledge and without their consent or connivance or in cases where they have acted diligently through the Board process.
- The Audit Committee was presented with the facts of only the first leg of transactions, through which funds were transferred to subsidiaries and group companies, and thus there was no allegation with respect to the said transactions.
- The funds were further diverted from such subsidiaries/group companies to other entities where the Executive Directors and Mr. Dinesh Jajodia were alleged to be personally interested, and the Noticees were not aware of such transactions forming the basis of the allegations.
- The relevant documents pertaining to the affairs of the subsidiary's companies were never placed before the Board of Directors.
- The Forensic Report admitted that the further investments made were not mentioned in the Audited Balance Sheet for the FY 2011-12.
- The report dated November 23, 2015, prepared by the Ministry of Corporate Affairs ("MCA") also pointed out towards complicity of the Executive Directors cum Promoters in taking all the financial decisions.
- The said report also indicated that the Executive Directors of the Company had been able to collect funds from the banks/Financial Institutions by falsifying the accounts and showing healthy balance sheets.
- There was no obligation on the Audit Committee Members to review the accounting entries themselves for which internal and statutory auditors were appointed. The test that had to be applied was "*what would a person with reasonable prudence would have commented on the documents presented during the meetings*".
- The SCN and Supplementary SCN treated all the Directors as guilty of fraud only due to their directorship, thus ignoring the law laid down under various judgments.
- Noticee no. 5 resigned on December 04, 2012, while Noticee no. 4 resigned on May 16, 2013, from the Directorship.
- Furthermore, Noticee no. 4 resigned on January 16, 2013, from the Audit Committee, as he was dissatisfied with the Management's inability to answer the questions raised by him. Copy of the emails indicating the same had been furnished by Noticee no. 4.
- The Management's accounts and audit confirmations provided to the Statutory Auditor and the Statutory Auditor's report dated December 03, 2012, did not contain any findings of fraud.
- The financial statements were recast on February 14, 2014, by that time, both had resigned from the directorship.
- Copy of minutes of meetings of Audit Committee for FY 2011-12 based on which allegations had been made was neither discussed nor furnished with the SCN and such documents are also not in possession of SEBI.
- SCN to Noticee no. 4 was issued by the MCA with respect to the irregularities

in the financial statements, however, ultimately, the MCA vide its letter exonerated him, based on the replies given.

- The materials available on record did not indicate that the Independent Directors could have detected the fraud by the management and being Independent Directors, the said Noticees had insight into the affairs of the Company only through Board processes.
- Reliance had been placed on the order dated September 09, 2019, passed by the Hon'ble SAT in the matter of ***Price Waterhouse & Co. vs. SEBI*** **(Appeal No. 6 of 2018)**, to contend that even a Statutory Auditor (leave alone Audit Committee Member) cannot unearth a complex fraud.
- As diligent Directors, queries were raised and upon not being satisfied, they resigned immediately from the post of the directorship even before the publication of the scam.
- There were no unusual changes in the financial statements of the previous year to raise any red flags.

Observation of Adjudicating Officer ("AO") of SEBI

- The AO found force in the submissions of Noticee Nos. 4 and 5 and observed that it was not a disputed fact that the Noticees, being Non-Executive Directors of the Company, were not involved in the day-to-day management of the Company and had also discharged their responsibilities in good faith and with due diligence
- There was no evidence on record which even remotely indicated that the alleged actions committed by the Executive Directors were committed with the knowledge, consent or approval of the Board of Directors and no specific adverse facts attributing their conduct or knowledge in the violations committed by the Company had been alleged in the SCN.
- Noticee no. 4 exercised his diligence by immediately resigning after becoming aware of the wrongdoings in the Company. Hence, he could not be held liable for the wrongdoings of the Company, which had been committed against the wish and consent of the Noticee.
- There was enough evidence which indicated that the complex, layered transactions were executed on behalf of the Company and the persons behind such acts were the Noticee nos. 1, 2 and 3 who were the Promoter-Directors of the Company, while there is nothing to show that the Audit Committee Members had knowledge of such transactions.
- The AO observed that while the Noticees i.e., Noticees no. 4 & 5 were certainly holding the post of Directors during the relevant period and that the two Directors were members of the Audit Committee, however, after perusing the submissions of the Noticees along with the materials available on record, the view that the submissions advanced by Noticee nos. 4 and 5, with supporting documents including the MCA letter holding Noticee no. 4 not as an officer in default, could not be ignored.
- Additionally, in the peculiar facts and circumstances of the present case, it had come to light that the facts, figures and the real state of affairs of the Company were concealed by the Executive Directors from the Audit Committee. In

this regard, the AO took note of the fact that Noticee no. 4 had resigned from the Directorship on account of the reasons cited.

- It was observed that the grave issues pertaining to Forex Trades, which led to a loss of INR 150 Crore to the Company, were kept hidden by the management from the Audit Committee Members. The AO also observed that such a glaring act of concealing the wrongdoings from the Audit Committee speaks volumes about the deceitful conduct of the Executive Directors, who were running the show of the Company.
- The aforesaid facts, even on a stand-alone basis, carried sufficient weightage to exonerate the Independent Directors of the Company.
- There was also no evidence to indicate their direct or indirect participation in the execution of the scheme devised by the Executive Directors, against whom strong observation had also been passed by the Hon'ble High Court for their wrongdoings, which also does not indicate any involvement or knowledge of the Independent Directors.
- The two Noticees had successfully exhibited that due diligence had been carried out by them while acting in the capacity of Independent Directors and that they had not acted as a mute or silent spectator to the nefarious activities of the Company.

Held

- The two Noticees had been successful in showing that due diligence had been carried out by them while acting in the capacity of Independent Directors and that they had not acted as mute or silent spectators to the nefarious activities of the Company.
- After becoming aware that the Company was not observing transparency in its affairs, Noticee nos. 4 and 5 had taken the decision to step down from the position of directorship.
- The charges made against Noticees no. 4 and 5 fell short of bringing home the allegations made in the SCN against them. Hence, such charges were not sustainable in light of the facts of the matter. Accordingly, the proceedings against them deserved to be dropped.
- The aforesaid observations thus exhibited the fact that the Independent Directors, who were part of the Audit Committee, were not furnished with complete and adequate information about the financial affairs of the Company. Furthermore, the essential information regarding huge losses incurred from Forex trading was also concealed from Noticee Nos. 4 and 5. Such conduct on the part of the management revealed the ill-intent of Executive Directors to keep the actual financials undisclosed from the investing public and regulatory authorities.
- In light of the facts, circumstances, as well as contentions of the Noticees, appraised thereof, it was observed that the facts of the case failed to provide adequate probabilities to establish the charges against the Noticee nos. 4 and 5.
- Therefore, both of the said Noticees were held to be exonerated from the impugned proceedings.

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CA Hardik Mehta CA Tanvi Vora

OTHER LAWS

FEMA – Update and Analysis

In this article, we have discussed recent amendments made in FEMA through Notifications, Circulars and Press Notes & Press Releases.

A. Update through Frequently Asked Questions

1. International Trade Settlement in Indian Rupees (INR)

The RBI issued 22 FAQs on International Trade Settlement in Indian Rupees (INR) on 1st December 2022 and can be accessed on **https://www.rbi.org.in/scripts/FS_FAQs.aspx?Id=151&fn=5**

(***Comments***: *RBI introduced the option of International Trade Settlement in Indian Rupees vide A. P. (DIR Series) Circular No. 10 dated 11th July, 2022. For our detailed comments on the introduction of the scheme, see our article in the CTC Journal of August 2022. The FAQs have aimed to provide more clarity to the circular and makes its implementation smoother. The FAQs have clearly clarified that the International Trade Settlement in INR a.k.a. Special Rupee Vostro Account (SRVA) is separate from existing Rupee Vostro Account option and is an additional arrangement available in order to reduce dependence on hard (freely convertible) currency.*

As everyone is aware, the process involves prior RBI approval. Banks are suggested to:

i) have a good level of business resilience and financial health

ii) they need to have experience in facilitating trade/investment transactions and capability to provide other financial services

iii) AD banks should have good correspondent relationships with banks in partner countries

RBI vide FAQ 4 has explained corresponding banking as relationship that acts as an intermediary or agent, facilitating wire transfers, conducting business transactions, accepting deposits and gathering documents on behalf of another bank. Correspondent banks are most likely to be used by domestic banks to service transactions that either originate or are completed in foreign countries. Domestic banks also use correspondent banks to gain access to foreign financial markets and to serve international clients without having to open branches abroad. Accordingly, it is clarified that SRVA is a bank-to-bank arrangement similar to correspondent banking arrangement.

The FAQs details a step by step procedure for opening SRVA and lists the documents to be attached with the proposal.

An Indian branch of a foreign bank is eligible to open SRVA of other branches in a foreign country. Also, foreign banks can maintain more than 1 SRVAs with different AD Banks. The FAQ also clarified that there is no country wise restriction, AD bank in India can open multiple SRVAs for different banks from the same country.

In case of exchange rates, the FAQs have carefully clarified that exchange rate between the currencies of the two trading partner countries will be market determined. Also, in the transition phase, when there is no market with direct exchange rates between two currencies (say INR and Sri Lankan Rupee), the exchange rate between the currencies of two trading partner countries, each of which has markets against global currencies, would be derived as a cross currency rate.

Balances in SVRA can be repatriated in freely convertible currency and/or currency of the beneficiary trading partner country depending on underlying transaction i.e. for which the account was credited. The income from INR balance can be repatriated subject to applicable regulatory guidelines and tax provisions. Balance in SRVA is like foreign exchange inflow converted into INR, hence balance can be used for any permissible current and capital account transaction (eg FDI, ECB) under the present FEMA framework. The FAQ has also clarified that balance of one SRVA can be transferred to SRVA of another bank of the same country only. Transfer from SRVA to Rupee Vostro account of same country is allowed but not vice-versa.

FPI license will not be required by the account holder overseas bank for investment in T-Bills and government securities from funds of SRVA with AD bank.

While the SRVA has been implemented by a few banks, however, its large scale impact is yet to be understood. The FAQs have still not provided clarity on availability of benefits such as duty drawbacks, export promotions, capital goods incentives and rebates on duties and taxes under different government which as are of now available only if the payments or export realizations come in freely convertible currencies such as the US dollar.)

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"Do not believe in a thing because you have read about it in a book. Do not believe in a thing because another man has said it was true. Do not believe in words because they are hallowed by tradition. Find out the truth for yourself. Reason it out. That is realization."

— *Swami Vivekananda*

"There are people in the world so hungry, that God cannot appear to them except in the form of bread."

— *Mahatma Gandhi*

Rahul Hakani
Advocate

Niyati Mankad
Advocate

Best of The Rest

BANK OF RAJASTHAN LTD. VS. VCK SHARES & STOCK BROKING SERVICES LTD. – ORDER DATED 10/11/2022 PASSED IN CIVIL APPEAL NO. 8972 - 8973 OF 2014 [SUPREME COURT]

Recovery of Debts due to Banks and Financial Institutions Act, 1993 – Borrower has option to file separate civil suit against the bank or counterclaim before the DRT

Facts

The Bank of Rajasthan (**"Bank"**) filed an application for recovery of the amounts due from VCK Shares & Stock Broking Services Ltd. (**"Borrower"**) before the Debts Recovery Tribunal, Kolkata (**"DRT"**). The Borrower entered appearance to defend the proceedings before DRT but also filed a civil suit before the Calcutta High Court and claimed a decree for sale of the pledged shares, recovery of sale proceeds, and an inquiry into the losses suffered by it along with a decree for payment of money. The Division Bench of Calcutta High Court relying on the judgment in ***Nahar Industrial Enterprises Ltd. vs. Hong Kong and Shanghai Banking Corporation [(2009) 8 SCC 646]***, held that a suit filed by a Borrower against the Bank was not barred before the Civil Court, although a suit filed by the Bank against the Borrower was barred. This was challenged by the Bank in SC.

Issues

1. Whether an independent suit filed by a borrower against a Bank or Financial Institution, which has applied for recovery of its loan against the plaintiff under the Recovery of debts due to banks (RDB) Act, is liable to be transferred and tried along with the application under the RDB Act by the DRT?

2. If the answer is in the affirmative, can such transfer be ordered by a court only with the consent of the plaintiff?

3. Is the jurisdiction of a Civil Court to try a suit filed by a borrower against a Bank or Financial Institution ousted by virtue of the scheme of the RDB Act in relation to the proceedings for recovery of debt by a Bank or Financial Institution?

Held

The Court held that there is no specific power in the civil court to transfer an independent

suit by the Borrower, to be tried by the DRT along with the Bank's application under the RDB Act. Accordingly, there is no question of transfer of the suit whether by consent or otherwise. Moreover, there is no provision in the RDB Act by which the remedy of a civil suit by a defendant against the bank is ousted. It is a matter of choice of the defendant. Such a defendant may file a counterclaim in the Bank's proceedings before the DRT or may avail the more strenuous procedure established under the CPC. The DRT, being a Tribunal and a creature of the Statute, does not have any inherent power which inheres in civil courts such as Section 151 of the CPC. Accordingly, the SC dismissed the Banks Application.

Mrs. Nandita Sarkar vs. Tilak Sarkar & Ors CRR 1857/2018 dated 21/12/2022 (Calcutta) (High Court)

Prevention of Women from Domestic Violence Act, 2005 (PWDV) - Also covers within its ambit, 'economic abuse'

Facts

Marriage between the petitioner and Saugata Sarkar (deceased) was solemnised on May 10, 2009 according to Special Marriage Act, 1954. After the said marriage the petitioner started to reside at the house of opposite party- 1 & 2 along with her husband and in-laws. After the marriage all the ornaments and other valuable articles which were gifted by the parents and parental relations of the petitioner as well as the other gifted items were kept at the in-laws house of the petitioner under the custody of the opposite parties. After a few days of marriage the petitioner found that her husband was not physically fit and was addicted to alcohol with other bad habits. The petitioner tried to her level best to restrain her husband from taking alcohol but the same was in vain. Finally the husband of the petitioner expired on October 29, 2010. The opposite parties along with other in-laws blamed the petitioner for the death of her husband and ultimately on the next day of death of her husband, the petitioner was forced to leave her matrimonial home. When the opposite parties did not return the streedhan articles the petitioner was compelled to file a criminal case u/s. 406 of IPC. After filing the criminal case and by virtue of the order of the Magistrate some articles were recovered from the house of the opposite parties. The petitioner also filed an application before the Jurisdictional Magistrate u/s. 12 read with section 18, 20, 22, 23 of PWDV Act, 2005 for getting monetary relief and for a direction to return all streedhan articles, compensation for causing Domestic Violence and also for interim monetary relief and interim residence. The prayers by petitioner was granted by the Trial court but turned down by the Sessions court.

Held

The Domestic Violence has been defined U/s 3 of the PWDV Act. The Domestic Violence includes economic abuse. The deprivation of petitioner to any economic or financial resources which the aggrieved person is entitled under any law- is also Domestic Violence. In this case it is the fact that the petitioner was deprived from her Stridhan articles since long which were under the custody of the opposite parties. This fact tantamount Domestic Violence. The facts of this case is peculiar in nature. The widow left the matrimonial home on the next day of death of her husband with an undertaking that she left voluntarily. This fact may have two explanations-

First, widow may have felt very alone in absence of her husband and took cozy shelter at her father's home;

Second, they are existed no good terms with her in-laws; that is the lady was not well at her matrimonial home.

What prompted the opposite party to obtain an undertaking at the time? Is they are in a supposition that the widow may proceed against them for their conduct during her living at matrimonial home? Thus, the written undertaking by father of the widow was obtained to avoid future complications/ proposed prosecution. This conduct by the opposite parties strengthen the petitioner's plea of Domestic Violence.

Learned Advocate for the OPs also argued that the petitioner has failed to prove "expenses incurred" or "loss is suffered" within the meaning of Section 20 of PWDV Act. It is admitted fact by both the parties that the petitioner who is a widow, has no independent income. She is now residing at her father's home at the mercy of her father. The day by day expenses of livelihood of the petitioner is not a deniable factor. She is only to lay her hand to her father for to meet out the daily expenses. Thus the circumstances incurred and loss suffered by the petitioner is itself proved from the facts and circumstances of this case. The argument advanced by the Learned Advocate on behalf of the opposite party has no merit on that score. Ultimately, it is the irony of fate, that instead of specific legislative intent, the widow lady is roaming doors of Courts since long 10 years without receiving any monetary relief.

HASMUKHLAL D. VORA & ANR. versus THE STATE OF TAMIL NADU CRIMINAL APPEAL NO. 2310 OF 2022 (Arising out of Special Leave Petition (Criminal) No. 8488 of 2022) dtd 16/12/2022 (Supreme Court)

Section 482 of Criminal Procedure Code, 1908 – Quashing of Criminal Complaint – Inordinate unexplained delay in filing complaint – relevant factor for quashing criminal complaint.

Facts

Appellant No.1 is the proprietor of M/s. Chem Pharm, and Appellant No.2 is the son and employee of Appellant No.1. During the course of their business, the Appellants purchased 75 Kg of pyridoxal-5-phosphate (as 3 x 25Kg packs). Drug Inspector, inspected the Appellants' premises and alleged contravention of S.18(c) of the Drugs and Cosmetics Act, 1940 (DaC Act) read with Rule 65(5)(1)(b) of the Drugs and Cosmetics Rules 1945. It was claimed that the Appellants broke up (0.5kg, 1kg, 10kg and 15kg) the bulk quantity of pyridoxal-5-phosphate and sold it to different distributors. The Drug Inspector issued a show cause memo to the Appellants after nearly three years. After a further lapse of one year and four months, the Respondent filed a complaint against the Appellants. The Appellants, in the High Court of Madras, sought for quashing of the abovementioned complaint u/s 482 of Cr.Pc and the same was dismissed on the grounds that a trial was necessary to ascertain the facts of the case, and an order was passed to expedite the trial.

Being aggrieved by the same, the Appellants filed the present Appeal, seeking to quash the criminal complaint against them.

Held

For the quashing of a criminal complaint, the Court, when it exercises its power under Section 482 Cr.P.C., only has to consider whether or not the allegations in the complaint disclose the commission of a cognizable offence. Impugned substance has been categorized as a bulk food substance. Alleged substance is not included as a drug in the Indian Pharmacopoeia, therefore does not require a specific license under the DaC Act, 1940. Dual-use substances, clearly are exempt from the requirements of Chapter IV of the DaC Act, 1940. Prima Facie, due to the lack of evidence adduced by the Respondent in the four-year gap period, this court cannot presume that the alleged substance can only be classified as a "drug". Even if assumed that the impugned substance is solely used for drug manufacture, even then, the Appellants would not be liable, since they already have the necessary Wholesale Drug License. No evidence has been provided by the officer to sustain the complaint. No recovery has been made from the premise of the Appellants, and no evidence has been provided to sustain the argument that the impugned substance is categorized only as a drug and requires a specific license. No efforts have also been made to show that the packaging of the impugned substance was broken up into various-size packets different from the original packaging from the original manufacturer. No recovery of the sold packets has been made to ascertain whether the original packaging was tampered with.

Even after lapse of substantial amount of time, no evidence has been provided to sustain the claims in the complaint.

Inordinate delay, if not reasonably explained, can be fatal to the case of the prosecution. While inordinate delay in itself may not be ground for quashing of a criminal complaint, in such cases, unexplained inordinate delay of such length must be taken into consideration as a very crucial factor as grounds for quashing a criminal complaint. Impugned order passed by the High Court is not liable to be sustained and is hereby set aside. The proceedings pending in the Court of Metropolitan Magistrate IV, stands quashed. Appeal stands allowed.

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"The goal of mankind is knowledge. That is the one ideal placed before us by Eastern philosophy. Pleasure is not the goal of man, but knowledge. Pleasure and happiness come to an end. It is a mistake to suppose that pleasure is the goal."

— *Swami Vivekananda*

"A thousand candles can be lighted from the flame of one candle, and the life of the candle will not be shortened. Happiness can be spread without diminishing that of yourself."

— *Mahatma Gandhi*

CA Vijay Bhatt
Hon. Jt. Secretary

CA Mehul Sheth
Hon. Jt. Secretary

THE CHAMBER NEWS

Important events and happenings that took place online/ physical between **1st December, 2022 to 31st December, 2022** are being reported as under:

I. ADMISSION OF NEW MEMBERS

The details of new members who were admitted in the Managing Council Meeting held on 23rd December, 2022 are as under:

Type of Membership	No. of Members
Life Member	04
Half Yearly Ordinary Member	05
Student Member	02
Associate Member	01
Total	**12**

II. PAST PROGRAMMES

Sr. No.	*Date*	*Topic*	*Speaker*
ACCOUNTING & AUDITING			
1.	The Accounting & Auditing Committee had planned a Physical program on "Full Day workshop on NBFC – Accounting, Audit and Regulatory Aspects" The session-wise detail for the program is as under:		
a.	10.12.2022	Keynote Address	CA Bhavesh Vora

Sr. No.	*Date*	*Topic*	*Speaker*
b.	10.12.2022	**Expected Credit Loss Provision** – Accounting Aspects – Auditing Aspects (Possible coverage: Accounting – Calculation of EAD, LGD, PD, Management Overlay, Scenario analysis, lifetime LGD, various models in practice, interaction with RBI IRAC provisions…. Auditing – Audit procedures for the models, scenario analysis, inputs, etc.)	Mr. Murtuza Vajihi
c.		**Effective Interest Method** – Accounting Aspects – Auditing Aspects (Possible coverage: Typical issues such as, rebasing for variable rates like MCLR, contractual life Vs. expected life, etc.) **Other Issues:** – Repossessed assets – Classification as Held for Sale – Deferred Tax – Securitisation/PTC/Direct Assignments Typical disclosures deficiencies in NBFCs	Mr. Santosh Maller
d.		**Scale based Regulations** effective from 1 Oct 2022 IRAC provision – daily NPA, upgradation, differential provisioning for standard assets for UL, new RBI IT outsourcing regulations, etc.	Mr. Kunal Mehta
e.		**Panel Discussion** - Regulatory challenges in meeting the heightened expectations of RBI	*Moderator:* Mr. Ashutosh Pednekar *Panellist*: Mr. Rakesh Bhatia Mr. Rahul Joglekar Mr. Gautam Shah

Sr. No.	Date	Topic	Speaker
		BENGALURU STUDY GROUP	
1.	23.12.2022	Principles emerging from the recent rulings of the Supreme Court in New Noble Education Society and Ahmedabad Urban Development Authority	CA H. Padamchand Khincha
		COMMERCIAL & ALLIED LAWS	
1.	16.12.2022	Lecture Meeting on Roles, Responsibilities and Risk of professionals under the PMLA Act	Aditya Ajgaonkar, *Advocate*
		DIRECT TAXES	
1.	09.12.2022	Lecture meeting on Unsettled issues on Direct Tax	CA Yogesh Thar
2.	12.12.2022	Recent Important Decisions under Direct Tax	CA Chirag Wadhwa
		INDIRECT TAXES	
1.	13.12.2022	Intricate Issues in Place of Supply provisions under GST	*Chairman* - CA Abhay Desai *Group Leader* CA Yash Dhadda
		INTERNATIONAL TAXATION	
1.	The International Taxation Committee had planned "1st Residential Refresher Conference on Foreign Exchange Management Act 1999 and its Rules/Regulations (with focus on practical aspects)" at Hilton Garden, Pune. The session-wise detail of the RRC is as under:		
a.	2nd to 4th December, 2022	Key Note Address	CA Rashmin Sanghvi
b.		Issues and challenges surrounding Resident Individuals and Non-Resident Indians/ Overseas Citizens of India (Including issues of inheritance and Trust)	CA Paresh P. Shah
c.		The new framework of Overseas Direct Investment (Emphasis on issues/challenges under the recently enacted Rules/Regulations)	CA Vishal Gada
d.		Recent Controversies/Issues under Foreign Direct Investment	Kishore Joshi, *Advocate*

Sr. No.	Date	Topic	Speaker
e.		Compounding of offences under FEMA, late submission fee (LSF), penalties & proceedings before the Enforcement Directorate etc	Moin Ladha, *Advocate*
f.		Brain Trust Session on various issues/case studies under FEMA	*Moderator*: CA Manoj Shah *Panelists*: Shri Himansu Mohanty (EX General Manager RBI) CA Dhishat Mehta, CA Shabbir Motorwala
2.	21.12.2022	Permanent Establishment - Intricacies - Part 1	CA Bijal Desai
MEMBERSHIP & PR			
1.	07.12.2022	Management in Professional and Personal Life	CA Atul Bheda
STUDENT			
1.	12.12.2022	GST Annual Return and Reconciliation	CA Yash Parmar
STUDY CIRCLE & STUDY GROUP			
1.	17.12.2022	Penalty for under-reporting and misreporting of income..Section 270A, 2) Immunity from imposition of PENALTY Section 270AA	Dharan Gandhi, *Advocate*
2.	22.12.2022	Recent judgements under Income Tax	Kavita Jha, *Advocate*

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"Our duty is to encourage every one in his struggle to live up to his own highest idea, and strive at the same time to make the ideal as near as possible to the Truth."

— *Swami Vivekananda*

"Liberty and democracy become unholy when their hands are dyed red with innocent blood."

— *Mahatma Gandhi*

Indirect Taxes Committee

11th Residential Refresher Course on GST was held from 5th January, 2023 to 8th January, 2023 at Westin, Pune.

Speakers

Advocate, Rohit Jain (Speaker) addressing the delegates.
Seen from L to R: CA Yash Parmar (Convenor), CA Haresh Kenia (Vice-President), CA Atul Mehta (Imm. Past Chairman) and CA Payal Shah

Senior Advocate, S. Ganesh (Speaker) addressing the delegates.
Seen from L to R: CA Deepali Mehta, K. Vaitheeswaran, Advocate, CA Paresh P. Shah and CA Vasant Bhat

Advocate, K. Vaitheeswaran (Speaker) addressing the delegates.
Seen from L to R: CA Raj Khona, CA Vikram Mehta, CA Manish Gadia and CA Parth Sanghvi

Senior Advocate, Tarun Gulati (Speaker) addressing the delegates.
Seen from L to R: CA Keval Shah (Convenor), CA A. R. Krishnan, CA Parag Ved (President) and CA Ravi Rathi

Group Photo

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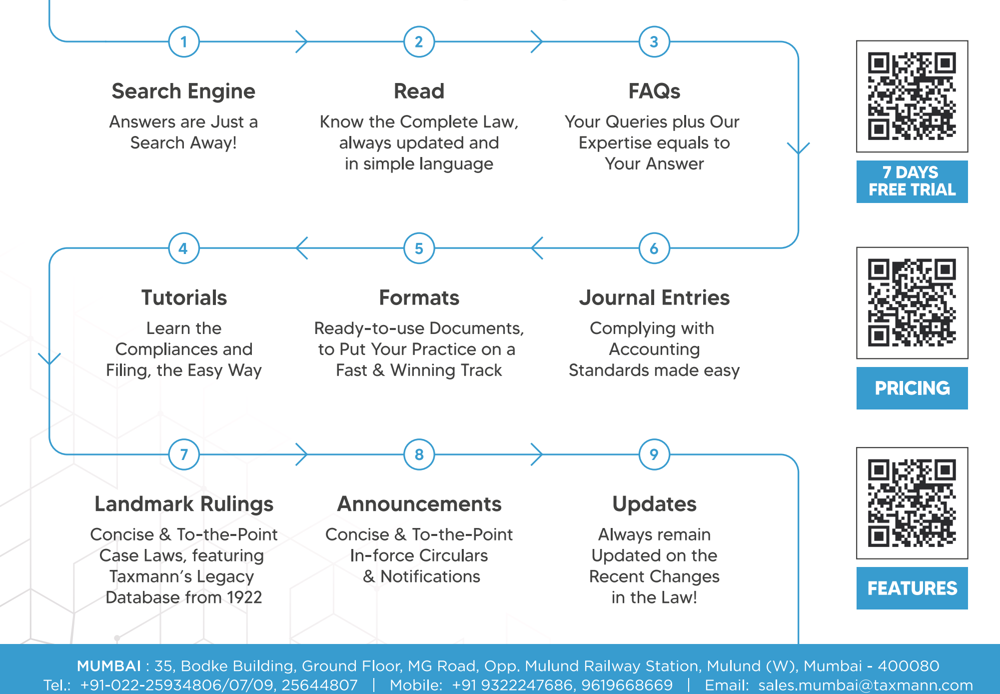

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