

CASE STUDY 2

An article singing paeans for India's space-tech start-ups appeared in "The New York Times" recently. The article underlined that India has become home to many such start-ups. It pointed out that space technology is fulfilling smaller-scale and commercial purposes like helping farmers in timely insurance of their crops. Space technology is also helping commercial fishing fleets in tracking their catch by sending images back to Earth. Satellites are bringing phone signals to country's remotest corners and are helping in operation of solar farms far away from India's megacities. It's also one of India's most sought-after sectors for venture capital investors.

Start-ups are mushrooming in different sectors of India's economy as varied as education, health, agriculture, fintech, clean energy, electric vehicles, bio technology, waste management, food processing and even drones. *Economic Survey for year 2022-23* highlights that by capitalising on the digital infrastructure support, India has also emerged as one of the world's most vibrant destinations for start-up ecosystems. Start-ups are being envisioned as the spine of new India. In fact, India is home to world's third largest start-up eco system.

GrowFine is an ed-tech start-up incorporated as a private company in April 2023. The founders of start-up believe that some benefits are available to start-ups under income tax law. However, they are unaware about nitty-gritty of the same as they are from engineering and management backgrounds. The company had launched its products in year 2023-24 itself and had a turnover of ₹ 20 crores. It is recognized by DPIIT (Department for Promotion of Industry and Internal Trade under Ministry of Commerce and Industry) and holds a certificate of eligible business and is recognized as a technology driven start-up by competent authority.

GrowFine has issued shares to certain investors who are familiar with founders of this ed-tech start-up during year 2023-24. They believe in the business idea of founders of the company and have decided to invest money out of their own resources. These investors are wedded to idea of providing quality affordable education to all and promoting standards of education in the country. In this way, their ideological belief stands aligned with mission of founders of start-up.

The start-up GrowFine has issued equity shares having face value of ₹ 10/-per share to these individuals @ ₹ 50/-per share during year 2023-24. The fair market value of equity shares of start-up as on valuation date is ₹ 11/-per share. The existing paid up share capital of company is ₹ 1.50 crores. The company has not issued shares at premium anytime in past.

GrowFine is still in nascent stages. However, it has already launched its products and has entered a segment of the market. The market has a considerable potential for company's

business to grow. Start-ups not only need finance but they also require favourable and conducive eco system to grow. It includes not only hand holding at time of germination of a business idea but also policy measures having a legislative backing. In India, relaxations and benefits have been provided to start-ups under various laws like under Income tax Act,1961 and Companies Act,2013.

GrowFine needs talented and skilled employees for its business. However, the company is not in a position to pay high cash salaries to attract and retain employees. It is, therefore, considering route of employee stock option plans (ESOPs). Employee stock option plans provide a chance to employees to become shareholders in the company and also be benefitted by its future growth. The company plans to draft an ESOP scheme containing matters relating to grant of option, vesting period and manner of determining exercise price among others. The company is approaching many talented persons for assuming various senior roles in its organizational set-up. One such senior person, Mr. X, has shown interest in joining the company. However, he is sceptical regarding income tax implications pertaining to ESOPs. He has a doubt that it may lead to withholding of tax by start-up impacting his immediate “in-hand” salary.

GrowFine is planning to merge another start-up company engaged in similar line of activity to increase its size, revenue and scalability. However, founders of the company are clueless regarding modalities of the same under relevant laws.

Valuation of start-ups is often required for bringing in investments. The value of a start-up is dependent upon its future growth prospects. It is also quite likely that such a business idea has never been tested before. It only lies in realms of future. Another problem in start-up valuation is totally new or non-comparable business products and strategies. Start-ups also depend upon many rounds of funding. GrowFine may also approach another set of investors in further rounds of funding.

I. Multiple Choice Questions

1. From the description given in case study relating to finance brought by individuals from their own resources and whose belief in promoting affordable education to all in the country and also improving its standards is aligned with mission of founders, which type of financing for a start-up is being referred to?
 - (a) Bootstrapping
 - (b) Venture capital financing

- (c) Funding by angel investors
 - (d) Factoring
2. The founders of GrowFine believe that some benefits are available to start-ups. Considering the description provided in case study, which of the following statements is in accordance with provisions of income tax law?
- (a) Company is eligible to deduction @ 75% of its profits from eligible business for any 5 consecutive assessment years out of 10 years beginning from the year in which start-up is incorporated. Further, certificate of eligible business in this regard is provided by Inter-Ministerial Board for Certification.
 - (b) Company is eligible to deduction @ 100% of its profits from eligible business for any 3 consecutive assessment years out of 10 years beginning from the year in which start-up is incorporated. Further, certificate of eligible business in this regard is provided by Inter-Ministerial Board for Certification.
 - (c) Company is eligible to deduction @ 75% of its profits from eligible business for any 5 consecutive assessment years out of 10 years beginning from the year in which start-up is incorporated. Further, certificate of eligible business in this regard is provided by CBDT.
 - (d) Company is eligible to deduction @ 100% of its profits from eligible business for any 3 consecutive years out of 10 years beginning from the year in which start-up is incorporated. Further, certificate of eligible business in this regard is provided by CBDT.
3. As regards doubt of Mr. X regarding withholding tax in relation to ESOPs is concerned, which of the following statements is most appropriate?
- (a) Income tax would be withheld at rates in force when option is exercised and shares are allotted to Mr. X.
 - (b) The company is an eligible start-up holding certificate of eligible business. Income tax would not be withheld when option is exercised and shares are allotted to Mr. X as such transactions are exempted from withholding tax in case of eligible start-ups.
 - (c) The company is an eligible start-up holding certificate of eligible business. However, such start-up is allowed to defer withholding tax when option is

exercised and shares are allotted to Mr. X. It is deducted in required manner after expiry of certain timelines and/ or happening of certain events.

- (d) Income tax would be withheld when option is granted. Such withholding tax would be deducted at the rates in force at time option is granted to Mr. X.
4. The start-up is planning merger with another start-up engaged in similar activities. Which of the following statements is in line with provisions of law regarding proposed merger of these start-ups?
- (a) It requires filing of proposed scheme with NCLT and final order in respect of merger is made by NCLT after following a detailed procedure.
- (b) It involves giving notice of proposed scheme to Registrar and Official Liquidators and approval of scheme by both the companies. After approval of scheme by creditors, the scheme is approved by Registrar of Companies.
- (c) It involves giving notice of proposed scheme to Registrar and Official Liquidators and approval of scheme by both the companies. After approval of scheme by creditors, the scheme is filed with Regional Director, Registrar and Official Liquidators. The scheme is finally registered by Regional Director.
- (d) It requires filing of proposed scheme with NCLT and final order in respect of merger is made by NCLT after following a fast-track procedure.
5. Which of the following is not a factor to be considered for valuing a start-up like GrowFine?
- (a) Past performance indicators
- (b) Educational background of founders
- (c) Uniqueness of product launched by start-up
- (d) Traction

II. Descriptive Questions

6. GrowFine has issued equity shares to individuals having face value of ₹10/-per share at a price of ₹ 50/-per share. What are income tax implications for the same for GrowFine? What is such tax commonly and popularly known as? Under which circumstances can GrowFine claim exemption from such a tax?

7. Start-up GrowFine is also planning to approach other investors to fund its business requirements. What specific points shall be considered while carrying out due diligence of such start-up for picking up an equity interest by a prospective investor?

ANSWERS TO THE CASE STUDY 2

I. Answers to the Multiple Choice Questions

1. (c) Angel investors typically use their own money. Often, they are among an entrepreneur's family and friends. They generally invest in small-start-ups and are attached to the idea of the business floated by start-up. However, venture capitalists take care of pooled money from other investors and place them in a strategically managed fund. Bootstrapping is an attempt to build the company from personal finances or from operating revenues of the company. Factoring is a method of bootstrapping.
2. (b) Under section 80-IAC (1) of Income tax act, 1961, where the gross total income of an assessee, being an eligible start-up, includes any profits and gains derived from eligible business, there shall, in accordance with and subject to the provisions of this section, be allowed, in 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 for three consecutive assessment years.
- (2) The deduction may at the option of the assessee, be claimed by him for any three consecutive assessment years out of ten years beginning from the year in which the eligible start-up is incorporated.
- Further, explanation to section 80-IAC also defines eligible start-up 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, 2024
- (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
3. (c) Under section 192(1C), 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 sub clause (vi) of sub-section (2) of section 17 in any previous year relevant to the assessment year, 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.
- Therefore, section 192(1C) provides for deferment of withholding tax in case of eligible start-ups.
4. (c) In case of merger between small companies/ start-ups, fast track procedure for merger has been prescribed under section 233 of Companies Act, 2013. It does not require filing of application with NCLT. The notices are to be given to registrar, official liquidator and Central Govt (powers delegated to Regional Director). After considering objections of registrar and official liquidator, the scheme is finally registered by Regional Director.
5. (a) In valuation of a start-up like GrowFine, there is no historical data on basis of which future projections can be drawn. Valuation of a start-up entirely rests on its future growth potential. The assessments of future growth are dependent upon competence and drive of persons running the business.

II. Answers to the Descriptive Questions

6. Under clause (vii) of Sub-section 2 of Section 56 of Income Tax Act, where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as

exceeds the fair market value of the shares is chargeable to income tax under head **“Income from other sources”**. Amount received by company which is in excess of fair market value of shares shall be taxable under the head “Income from Other Sources.” This tax is commonly and popularly called as **“Angel tax”**.

However, this clause shall not apply where the consideration for issue of shares is received—

- (i) by a venture capital undertaking from a venture capital company or a venture capital fund or a specified fund; or
- (ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Accordingly, the Central Government has, vide Notification No. 30/2023 dated 24.5.23 notified that the provisions of section 56(2)(viib) of Income-tax 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 any person, by a company which fulfils the following conditions specified in para 4 of notification number GSR 127(E) dated 19.2.2019 issued by Ministry of Commerce and Industry in the Department for Promotion of Industry and Internal Trade (DPIIT).

- (i) it has been recognised by DPIIT under this notification or as per any earlier notification on the subject
- (ii) Aggregate amount of paid- up share capital and share premium of the startup after issue or proposed issue of share, if any, does not exceed, twenty five crore rupees.
- (iii) It has not invested in any of the following assets, —
 - (a) Building or land appurtenant thereto, being a residential house, other than that used by the Startup for the purposes of renting or held by it as stock-in-trade, in the ordinary course of business
 - (b) land or building, or both, not being a residential house, other than that occupied by the Startup for its business or used by it for purposes of renting or held by it as stock-in trade, in the ordinary course of business
 - (c) loans and advances, other than loans or advances extended in the ordinary course of business by the Startup where the lending of money is substantial part of its business

- (d) capital contribution made to any other entity
- (e) shares and securities
- (f) a motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds ten lakh rupees, other than that held by the Startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business
- (g) jewellery other than that held by the Startup as stock-in-trade in the ordinary course of business
- (h) any other asset, whether in the nature of capital asset or otherwise, of the nature specified in section 56(2)(vii)(d) (iv) to (ix) of the Act.

It has been further provided that the startup should not invest in any of the above assets for the period of seven years from the end of the latest financial year in which shares are issued at premium.

A start-up fulfilling above conditions has to file a form with DIPP which is forwarded by it to CBDT. By fulfilling above conditions and taking advantage of above notification, start-up can claim exemption from paying angel tax.

7. A prospective investor shall carry out due diligence before picking up equity interest in a start-up. Background of the promoters and credentials would be looked into. It is necessary to verify start-up's claims regarding future growth and numbers. The prospective investor should be convinced about business model of start-up and type of service provided by it. The start-up should be differentiated to meet specific customer needs or to solve a unique customer problem. Besides, start-up should show potential to scale up in near future in accordance with a suitable business plan.

The prospective investor would also look for market size and likely obtainable market share and macroeconomic drivers for the market. The extent of competition in the market in this segment also needs to be looked at. Nonetheless, investor would also be looking for exit avenues. The investor would also be taking into account the fact whether a start-up is showcasing potential future acquirers or alliance partners. It is a valuable parameter for the investor. Subsequent rounds of fundings and acquisitions all are examples of exit options.