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An Analysis of the Tax Incentives aimed at Fostering Entrepreneurial Spirit in India

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India has been and is a land of entrepreneurs. After Independence, the citizens of India were engaged in entrepreneurship in some form or other. They had to contend with bureaucracy in obtaining various approvals to start their business and comply with laws that prevented people from setting up their businesses. After the economy of India was liberalized by the government in 1991, the people of India became aware of different opportunities. Many laws and rules were done away with. The economy of India grew and expanded at a rapid rate. The number of small and medium entrepreneurs grew at a rapid rate. The government of India took cognizance of the contribution of entrepreneurs in generating employment opportunities and their contribution to the growth and development of the Indian economy. India has the largest young and most productive workforce in the world. To harness the demographic dividend of India, the government has announced various policies to encourage entrepreneurs and also has provided various tax incentives to encourage the development of entrepreneurs in the country. These incentives and policies were introduced at different points in time after the liberalization of the Indian economy. The object of this article is to analyze the various tax incentives to encourage entrepreneurship among the citizens of India.

Keywords: *tax incentives, entrepreneur, liberalization, incentives, policies.*

INTRODUCTION

Ever since the economy of India was liberalized in the year 1991, it has grown steadily and is presently growing faster than many developed economies. In the last three decades, the Indian economy has grown at a fast pace as many macroeconomic and structural reforms reduced regulations significantly and improved the ease of doing business. India is fast becoming a global hub for business and financial transactions. In the era of globalization, India offers a cost-effective environment for establishing and doing business for the growing domestic and export markets. The Indian economy offers many avenues for growth and profits on investment in all areas of business. The market in India is very diverse with different sections of consumers having diverse tastes and preferences thereby ensuring a vast market for all areas of business.[1] India is home to the largest and youngest working-age population in the world and the number of Indian youths interested in becoming job creators has been increasing steadily. They venture out into new innovative fields, take the risk and emerge as entrepreneurs. However only a small number of entrepreneurs succeed and many of them fail due to a lack of professional guidance, lack of investments, inexperienced entrepreneurs, etc.[2]However, the potential of small businesses in job creation and economic growth cannot be ignored.

While keeping this prospect at the forefront, the government provided a lot of measures to encourage entrepreneurs to start new businesses and generate employment and contribute to the economy of the country. Many incentives were introduced at various points of time in the annual Budget keeping in mind the need to encourage the development of businesses and industries throughout the country in a uniform manner. Deductions and exemptions were given to those who wanted to start a certain specified business in specific regions of the country. The Prime Minister of India on 15th August 2015 announced the Startup India Initiative. The main objective of this flagship initiative was to build a strong ecosystem that will nurture innovation in the country which will result in economic growth and generate employment opportunities. Further to this, an Action Plan for Startup India was also unveiled by the Prime Minister of India

[1] ' Business Guide Start-up to Set-up' (*Wolters Kluwer*, 2015) <https://www.vaishlaw.com/wp-content/uploads/2019/02/India-Business-Guide-Start-up-to-Set-up-2018.pdf> accessed 27 January 2023
[2] Vinod Kothari Consultants, *Guide to Start-ups* (1st edn, Taxmann 2016)

on 16th January 2016.[3] The Action Plan enumerated 19 action points covering different areas. The driving objective behind the action plan was to speed up the spread of entrepreneurship to a wide array of sectors in the Indian economy and also to spread the startup movement across semi-urban and rural areas. The Startup India Initiative is an ongoing initiative where important decisions will be taken by engaging with the stakeholders. Since its inception, 28,979 startups have been recognized by the DPIIT as of 01.03.2020.[4] According to the Notification issued by the DPIIT dated 19th February 2019, a startup to be considered as a 'recognized startup', which is eligible for benefits under the Action Plan announced by the government, is required to satisfy the following conditions:[5]

- The entity must be registered in India as a startup for 10 years either as a partnership firm company, or an LLP.
- The startup entity must not have a turnover of more than ₹100 crores during any of the said 10 years.
- The startup entity should not have an aggregate paid-up share capital and premium of exceeding ₹25 crores in any of the 10 years.
- The startup entity must submit Form 2 with the DPIIT which shall be automatically sent to the Central Board of Direct Taxes to take exemption from angel tax.
- The entity is not the result of restructuring or split up of a business already in existence and therefore should be a new entity.
- The startup entity should be working towards the development of innovative products and services or should have a business model that has a high potential for generating employment and wealth.[6]

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[3] 'Features of Startup India' (*Ministry of Commerce & Industry*, 11 March 2020) <https://pib.gov.in/PressReleasePage.aspx?PRID=1605956> accessed 24 January 2023

[4] *Ibid*

[5] 'Gazette of India' (*Department for promotion of Industry and Internal Trade*, 19 February 2019) <https://dpiit.gov.in/sites/default/files/notification_Definition_StartupIndia_06July2021.pdf> accessed 24 January 2023

[6] Features of Startup India (n 3)

TAX BENEFITS AVAILABLE FOR A STARTUP RECOGNIZED AS PER THE ABOVE DEFINITION

1. Benefits to Investors in Startups - Section 56(2)(viib)

Section 56(2)(viib) was inserted from the assessment year 2013-14. It is applicable as follows:

- The recipient is a company in which the public is not substantially interested.
- It receives consideration for the issue of shares, either preference or equity shares from a resident person.
- The consideration so received for the issue of shares exceeds the fair value of such shares. In other words, shares are issued at a premium.

If these conditions are satisfied, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income tax in the hands of the recipient company under this Section under the head 'Income from other sources'. However, the startups recognized by the DPIIT are exempt from tax under Section 56(2)(viib) of the Income Tax Act of 1961 when such a startup receives any consideration for the issue of shares which exceeds the Fair Market Value of such shares from a resident person. If the consideration is received by a venture capital undertaking from among others a specified fund which has been defined to mean a Category I or Category II Alternative Investment Fund which is regulated under the SEBI(Alternative Investment Fund) Regulations of 2012 and from the assessment year 2023-24 a Category I or Category II Alternative Investment Fund which is regulated under the International Financial Services Centres Authority Act of 2019.[7] This benefit is popularly referred to as 'Angel Tax'.

2. Income Tax Exemption for 3 years

When entrepreneurs start their businesses, they are trying to evaluate the feasibility of their business idea. They make significant investments in constantly improving technology. They have to deal with rising competition and challenges associated with the venture. To help the

[7] Dr Vinod K Singhania, *Direct Taxes Ready Reckoner* (46th edn, Taxmann 2022)

startups and assist them in their development it is necessary to provide them with some relief in the form of a tax holiday for a certain number of years.

Under Section 80-IAC of the Income Tax Act of 1961, which became applicable from the Assessment Year 2017-18, an eligible startup shall be allowed to get a 100% deduction on the profits and gains of business for any of the 3 consecutive assessment years out of 10 years commencing from the year of its incorporation, at the option of the assessee. This deduction is given is to enable the startup to strengthen itself and meet its capital requirement. This benefit is given to a recognized startup subject to the following conditions:

- The startup must be formed after March 31, 2016, but within April 1, 2023.
- It should not have a turnover exceeding ₹100 crores in any of the years during the block of 10 years.
- The startup should have obtained the certification from the Inter-Ministerial Board of Certification to carry out its eligible business.

3. Tax exemptions on long-term capital gains

A recognized startup is eligible to get tax exemption on long-term capital gains under the following sections.

Section 54 EE: This Section became applicable from the assessment year 2017-18. If a recognized startup transfers a capital asset which is a long-term asset in nature and invests the capital gains in specified assets to be specified by the Government to fund startups, such capital gains shall be exempted Such investment shall be made within 6 months from the date of transfer of original asset. The exemption is the amount of capital gain or the value of the long-term specified investment. Such investment in a specified asset shall not exceed ₹50 lakhs in any financial year. Such capital gain is exempted from tax. Such investment shall not be transferred within 5 years of making such investment. The exemption will stand revoked if the long-term specified investment is transferred within 3 years from the date of such investment and the exempted gains will be chargeable to tax as a long-term capital gain.[8]

Section 54 GB: This Section became applicable from the assessment year 2013-14. This provision was extended to include startup businesses under the Startup India Action Plan. This encourages entrepreneurs to start new enterprises by funding them through their assets. Where an individual or HUF sells his residential house or land and invests the proceeds of such sale in subscription of equity shares of an 'eligible startup' or 'eligible company'. Such 'eligible company' or 'eligible startup' should utilize this amount for purchasing a 'new capital asset' within one year from the date of such subscription. If the company or startup fails to invest the subscription money to purchase the capital asset within one year of subscription, it can deposit the amount in a capital gain deposit account. Such capital gain is exempted from tax for the such assessee. Such investment in the eligible startup is subject to a lock-in period of 5 years. [9] The exemption under this provision is calculated as follows:

[Investment in a new asset by the eligible company / Net sale consideration x Capital Gain]

Where Net sale consideration is sale consideration minus the expenditure on transfer incurred by the transferor. This exemption will be revoked and such capital gain will be taxed as income of the assessee if the assessee does the following:

The equity shares of the eligible company or eligible startup are sold within 5 years from the date of its acquisition. Where the new asset is a computer or computer software acquired by an eligible startup and is sold within 3 years from the date of acquisition or in the case of any other asset within 5 years from the date of acquisition. For this section, an 'eligible startup' or 'eligible business' refers to the following:

'Eligible business' refers to a business that involves innovation, development, deployment, or commercialization of new products, and services through the use of technology or intellectual

[8] *Ibid*
[9] *Ibid*

property. An 'eligible startup' refers to a company engaged in the eligible business and meets the following conditions:

- It must be incorporated between April 1, 2016, and March 31, 2022.
- The turnover of the business does not exceed ₹100 Crores in any of the previous years between April 1, 2016, and March 31, 2022.
- It holds the certificate of eligible business from the Inter-Ministerial Board of Certification as notified by the government.

'New asset' refers to 'new' plant and machinery which shall not include second-hand plant and machinery, plant and machinery installed in the office premises/residential accommodation or a guest house, any office appliance, any vehicle, any plant and machinery for which depreciation of 100% has been allowed in any previous year.

Fund of Funds for Startups (FFS)

Under the Action Plan, tax exemption has been made available to investors of Fund of Funds which have been set up by the Government to meet the financial requirements of startups. The government has set up a fund of funds with an initial corpus of ₹10,000 crores spread over 4 years based on the availability of funds. Small Industries Development Bank of India is the operating agency for the FFS. A fund of funds is a fund that invests in the instruments issued by other funds. As per the Action Plan announced by the Government, Fund of funds will have exposure to various SEBI-registered venture capital funds which will invest in startups through equity or equity-based instruments. To facilitate contributions to the fund of funds, where a person invests the capital gains in the fund of funds, such capital gains should be exempt from taxes in the hands of such investors.[10]

SOME OTHER TAX INCENTIVES TO FOSTER ENTREPRENEURSHIP

Before the announcement of the 'Startup India Standup India initiative', the central government had introduced several tax reforms to encourage entrepreneurs by amending the Income Tax

[10] Vinod Kothari Consultants (n 2)

Act of 1961 at different points in time. The central government introduced tax reforms for the growth of certain specified industries in certain sectors of the economy. Some of the tax reforms also provide incentives to start new businesses in certain specified regions of the country, to encourage balanced economic development. Some of the other benefits which have been made available to new businesses and startups are as follows:

Under Section 115BAB, a new manufacturing domestic company will be charged tax at the rate of 15% subject to the condition that such business does not claim other benefits available to a company under the Income Tax Act of 1961. The new manufacturing company has to be set up and registered on or after October 1, 2019, and begin manufacturing operations on or before March 31, 2024. Such a new company should not be formed as a result of the splitting up or reconstruction of an existing company. The plant and machinery should be new. And should not use old plants and machinery on which depreciation has already been claimed. The primary business of the new company should be manufacturing and it should not be engaged in any other business. The new manufacturing should not be using an old hotel or convention center in respect of which deductions under the Income Tax Act have already been claimed. Provisions related to domestic transfer pricing shall apply to these new companies. In case the new company fails to comply with the requirements of this section in claiming the benefit of paying tax at the rate of 15%, then the benefit of reduced tax rate shall not be available in the year of non-compliance and any subsequent year thereafter. However, the company can claim the benefit of being governed under the provisions of the reduced tax rate of 22%.[11]

Under Section 35AD, investment-linked tax incentives are made available for investing in the plant and machinery of a total of 14 specified businesses. The business started by the assessee should be one among the 14 specified businesses specified by this Section. The investment should be made to start a new business and it should not be set up by splitting up or reconstructing an existing company. It should also be using new plants and machinery and not

[11] *Ibid*

existing or second-hand machinery. 100% of the amount invested wholly or exclusively for the 'specified business' is deductible in the previous year in which the amount was invested.

The investment in the newly specified business shall not include the acquisition of land, goodwill, or financial instrument. From the assessment year 2018-19, this incentive is available only if it is made by account payee cheque/draft/use of an electronic clearing system through a bank or by prescribed electronic modes like a credit card, debit card, net banking, Immediate payment service(IMPS), Unified payment interface(UPI), Real-time gross settlement(RTGS), National electronic fund transfer(NEFT) and BHIM(Bharat Interface for money). The investment incurred before the commencement of the operation, wholly or exclusively for the 'Specified business' is allowed as a deduction in the previous year in which the assessee commenced his operation if the amount of such investment is entered in the books of the assessee as on the commencement of operation.[12]

Those assessees who claim the benefit under Section 35AD are subject to certain liabilities. Once deduction is claimed under this section, the assessee will not be able to claim deduction under the provisions of Sections 80HH to 80RRB for the year in which the benefit under Section 35AD has been claimed and any other subsequent year. No deduction will be allowed under any other provisions of the Income Trax Act, to those assessees who have claimed benefit Under Section 35AD. The assets of the specified business should be used only for the specified business for 8 years from the date of its acquisition or construction failing which the amount of deduction claimed and allowed in any previous year in respect of such asset as reduced by the depreciation will be treated as business income of the assessee of the previous year in which asset is so used. Any loss of the specified business shall be set off against the profits and gains of any other specified business only and unabsorbed loss if any can be carried forward and set off against the profits and gains of the specified business only. In case, any sum is received or is receivable on account of any capital asset in respect of which deduction has been claimed under this section

[12] *Ibid*

such amount shall be treated as the income of the assessee under the head profits and gains of business income.

Under Section 35D any preliminary expenses incurred by a resident-non-corporate assessee or Indian company before the commencement of business qualify for amortization. The benefit of amortization is available for setting up any new undertaking or business unit with effect from the assessment year 2009-10. The qualifying expenditure shall not exceed 5% of the cost of the project. While the ceiling limit of 5% of the cost of the project applies to all assessees, an Indian company is given the option to opt for an alternative limit of 5% of capital employed. One-fifth of the qualifying expenditure is allowed as a deduction in each of the five consecutive years beginning from the year in which the business commences or the new industrial unit commences production or operation.[13]

There are also some tax incentives provided under Chapter VI-A of the Income Tax Act of 1961. These tax incentives are enumerated in Sections 80-IA to 80-IE of Chapter VI-A. They are deductions available to all assesses from the year on which these assesses commenced their businesses, on incomes or receipts earned or received by assessees that carry on certain types of specified businesses to be carried out in certain specific regions of the country. These provisions under Chapter VI-A have been inserted to promote entrepreneurship in all regions of the country and all sectors of the economy so that there will be a balanced growth of the Indian economy.

CONCLUSION

The Government of India recognized the importance of promoting entrepreneurship among the citizens and also the contributions of entrepreneurs in generating employment opportunities and their contributions to the economic development of the country. To this end, the government has made and is making unprecedented efforts to promote entrepreneurship

[13] *Ibid*

among the masses by providing various tax incentives to those citizens who are desirous of becoming entrepreneurs.