Private equities, venture capital funds get tax breather for startups

Private equity (PE) and venture capital (VC) funds investing in startups have got a tax relief. Income from transfer of unlisted shares by them would now be treated as capital gains and not as business income even if there is transfer of control or a management change.

A number of funds had received show cause notices from income-tax authorities on this issue, prompting a spate of representations from them as well as startups to the Central Board of Direct Taxes (CBDT).

The relief is available to Sebi-registered Alternate Investment Fund (AIF), both category I and II.

The board has now sent out a letter to the field saying this change in control or management should not be applied in case of such investments as AIFs typically invest in unlisted shares of ventures, many of which are startups, making some form of `control and management of underlying business' necessary. This issue had its origin in the long-standing debate on treatment of transfer of shares as business income or capital gains.

The CBDT had in February 2016 through a clarification settled the debate that income from transfer of listed shares and securities which are held for more than a year would be taxed under the head `Capital Gain' unless the taxpayer himself treats these as stock-in-trade and transfer thereof as its business income.

For determining the tax-treatment of income from transfer of unlisted shares for which no formal market exists for trading, the CBDT said the income would be considered as `Capital Gain', irrespective of period of holding, but with some exceptions.

These included a situation when genuineness of transactions in unlisted shares itself was in question, transfer of unlisted shares was related to an issue pertaining to lifting of corporate veil or the transfer of unlisted shares is made along with the control and management of under lying business.

The board has now dropped this condition that impacted startup investments by VCs and PEs as their funding usually implies some form of management control.

Tax experts say the CBDT clarification helps remove any uncertainty and risk that gains from sale of shares in such cases could be taxed as business income.

“Taxing them as business income would have been a big blow since they invest for a longer duration and would have lost out on indexation benefit or full capital gains exemption (in cases of favourable treaty countries like Mauritius, Singapore, the Netherlands, etc.),” said Amit Maheswari, partner at Ashok Maheshwari & Associates LLP.

“The clarification addresses the concern and ambiguity caused by the exception to the broad principle laid out by the earlier guidance issued by the government that income arising from transfer of unlisted shares should be considered as capital gains,” Vikas Vasal, national leader tax, Grant Thornton India LLP .

Tax experts have now sought further certainty in the Budget. “It is common for AIFs to acquire management control of the investee companies... This is a very important clarification also considering that business income does not get pass through status. Investors in such AIFs can therefore get the benefit of lower tax rate on capital gains," said Rajesh Gandhi, partner, Deloitte Haskins & Sells LLP. "The Budget 2017 should in fact remove the differential tax treatment between capital gains and business income and simply give pass through status to all types of income of AIFs," he said.

(Economic Times)