Unmasking Angel Tax: Ramifications of the 2023 Amendment

Ashutosh Mohan Rastogi

Managing Partner, Amicus, Advocates & Solicitors

Dhruv Seth

Managing Associate, Amicus, Advocates & Solicitors

Kartikey Vashist

Research Associate, Amicus, Advocates & Solicitors

Finance Act 2023 struck the nerves of investors and start-ups by amplifying the scope of the vexed 'Angel Tax' - including non-resident investors within its purview.

The new provisions come across as the antithesis of 'Invest in India', at least in their current iteration. And while the subsequent CBDT Notifications[1] attempted to assuage fears, the underlying issue persists. This article dives into these new provisions, their implications for start-ups, and tax planning for prospective 'angels'.

Objective of Section 56(2)(viib) :

Memorandum to Finance Act 2023 states that Section 56(2)(viib) of the Income Tax Act 1961 ('the Act') was inserted vide Finance Act, 2012 to prevent the generation and circulation of unaccounted money through share premium received from **resident investors**. The 2023 amendment, however, included the consideration received from a non-resident also under the ambit of section 56(2)(viib) by removing the phrase 'being a resident' from the said clause.

Ostensibly, the amendment reiterated the original objective for expanding the scope of Section 56(2)(viib), without providing a rationale for the same. The modus operandi exercised by tax authorities in enforcing this provision renders the original objective peripheral and irrelevant. Investors have been receiving notices from the department, examining their creditworthiness, despite the fact that the source of funds was never in doubt. The manner in which Section 56(2)(viib) is being applied is without any regard to its original intention i.e., preventing the circulation of black money.

Ironically, the term 'angel tax' now seems like a contradiction by and of itself, as we discuss angels on one hand, and tax them on the other. In order to analyze the ramifications of the new provisions, let us briefly look at the changes introduced in Finance Act 2023 and subsequent notifications *vis-à-vis* the erstwhile provisions.

Table 1: Section 56(2)(viib) – Pre & Post Amendment

Pre-Amendment	Post-Amendment
Only 'resident' investors covered	Both **'resident'** and **'non-resident'** investors covered
Rule 11UA - Only Two methods (*i*) DCF (Discounted Cash Flow) (*ii*) NAV (Net Asset Value) method	Five Additional Valuation methods provided under Draft Rule 11UA for Non-residents (Aligning with FEMA) 1. Comparable Company Multiple Method 2. Probability Weighted Expected Return Method 3. Option Pricing Method 4. Milestone Analysis Method 5. Replacement Cost Methods
Exclusions: DPIIT registered Start-ups (meeting specified conditions) Amount of paid up capital does not include funds from Non-residents and Venture capital funds.	Exemption from Angel Tax extended to **'notified entities'** from **'Specified Nations'**
Price Matching Method not available	**Price matching** for both resident and non-resident investors
Safe Harbour not available	**Safe harbour** for both resident and non-resident investors
Contemporaneous valuation report is required but no time period for validity specified	**90 days** specified as the time period for validity of valuation report (at option of assessee)

It is pertinent to note that the new developments brought about by the 2023 Finance Act have a limited scope. As stated above, angel tax provisions will not apply to 'notified entities' from 21 'specified territories'. Surprisingly though, the list omits some of the largest sources of foreign investment in India:

Table 3: Source Country and Rank of FDI in India

COUNTRY	Source of FDI into India (since FY 2000)
Mauritius	1st
Singapore	2nd
Netherlands	4th
UAE	7th

Eliminating investments from the above nations raises questions regarding the constraints on equity inflows into India as well as diplomatic maneuvering. Interestingly, Mauritius has sought clarification regarding its exclusion from the list of exempted countries, even though the island nation complied with all 40 FATF recommendations on Anti-Money Laundering & Countering financing of terrorism.

Risky Gambit - Singapore and Mauritius left out

The repercussions, if any, of overlooking such massive sources of FDI will only be realized in time. However, one of the possible rationales for taking this step could be a shot in the arm for GIFT City.

India's first International Financial Services Centre (IFSC) at GIFT City provides a plethora of fiscal incentives, including, inter alia, 100% tax exemption for 10 consecutive years out of 15 years[2]. The new provisions also exempt funds established in the IFSC from angel tax on shares issued by unlisted Indian companies.

However, the billion(s)-dollar question is whether GIFT City can fill the void left by Singapore and Mauritius based FDIs in the near future. The $102 Million investment through GIFT City in FY 2022-23 does not inspire much confidence, especially under the massive shadow cast by investments from Offshore financial centres. For the sake of context, FY 2000-2023 saw cumulative equity inflows from Mauritius amounting to nearly $164 Billion. FDI inflows from Singapore stood at $17 Billion ***just*** for FY 2022-23.[3]

The above statistic is not meant to serve as a reminder of Indian dependence on capital from tax havens, but it would be rather myopic to dismiss the importance of such equity infusion in economic growth, employment, technology, and increments in export.

Price Matching

Price matching is a novel method introduced in the draft valuation notification[4]. It construes that the price derived as 'FMV' by a 'Notified' entity can be taken (at the option of the investee) as 'FMV for other investors (not 'Notified' entity) in another/ subsequent round, if:

1. Amount invested in the next round does exceed the 'aggregate consideration' received from the notified entity; and
2. The prior investment round is within a period of 90 days from the next issue of shares

ILLUSTRATION [5]

Let us say a notified entity subscribes to 1,000 equity shares of an unlisted company at FMV of INR 50 per share.The investee has the option to take INR 50 per share as FMV for other investors (not 'Notified Entity'). However, this FMV can be applied upto an investment of Rs 50,000 only ('Aggregate Consideration' Received'); and the subsequent investment has to be within 90 days of the receipt of consideration from 'Notified Entity'.

There could be potential disputes over the meaning of 'aggregate consideration' used in the draft notification. If the first round of funding takes place over several tranches, and only one of the tranches falls within the 90-day period, then in our opinion, the FMV for the total consideration (across all tranches) by the notified entity would be accepted as the FMV for subsequent rounds of funding, significantly increasing the size of the aggregate consideration. The intention of the Government seems to be to enlarge the scope of Price matching method rather than restrict it.

Safe Harbour

Safe harbour 'not exceeding 10%' is made available, which means if the issue price exceeds FMV by not more than 10 percent, the issue price is accepted as FMV.

Safe harbour available for both resident and non resident investors

Available in case of DCF, NAV and additional methods

Not available in case of 'Price Matching' Method

Greater breathing room for start-ups

Welcome move that recognizes valuation is not a science but a matter of perception

Table 3:Concerns for Investors & Start-ups:

Investor	Start-up
Must have tax-efficient exit options	Downward pressure on valuation
Get an investment price that matches the perception	Fear of Tax Scrutiny on valuation (plus tax litigation cost)
FEMA Regulations require investment above FMV but tax regulations tax excess	Unreasonable Tax Demands from start-ups already cash strapped
Investment must be at FMV (subject to 10% safe harbour) to satisfy both FEMA and Tax Regulations	Double Whammy for loss making Start-ups – easy prey for Angel Tax Challenge

Angel Tax: Whether Applicable to Preference Shares/CCDs?

The express language of Section 56(2)(viib) states "any consideration for ***issue of shares*****".**

In *Asstt. CIT* v. *Golden Line Studio (P.) Ltd*.[6], the Tribunal held that preference shares stand on a totally different footing as compared to equity shares and thus section 56(2)(viib) cannot be made to apply circumstances.

In the case of conversion (CCDs), the capital has already been contributed by way of debentures earlier and is now merely changing from 'loan' to 'equity'. In other words, there is no fresh infusion of funds in case of conversion and therefore there is no logic in applying the strict deeming provision of 56(2)(viib) which is an anti-abuse provision.

Since Section 56(2)(viib) is a deeming provision, it needs to be construed strictly. In order to prevent any arbitrary or ad-hoc exercise of power, the legislature did not leave it open to tax authorities to bring within its purview any transaction except 'issue of shares' as expressly stipulated in the section. Therefore, CCDs and Preference shares should remain outside the scope of Section 56(2)(viib).

PLANNING AROUND ANGEL TAX

DPIIT Registration - According to an official from the Revenue Department, Over 80,000 DPIIT-registered start-ups will not come within the angel tax purview. Hence, DPIIT registration is the first and foremost way around angel tax. However, this is only applicable to entities meeting thresholds of having a paid-up capital of not more than INR 25 crores and revenue of not more than INR 100 crores. For entities unable to meet DPIIT thresholds, the following may be pertinent:

Choice of Entity and Jurisdiction

Flip Structure – Setting up companies outside India and raising money there, instead of in India

If money is to be raised in India, then raise funds through notified entities in specified territories. Full or part investment may be through Notified entity combined with Price Matching Method, but within the 90-day period, and this FMV can be relied upon for resident investors as well.

Choice of Instrument

Instead of going for the traditional choice of instrument (equity), start-ups might move towards debt instruments for raising funds from foreign investors.

CCPS – Technically not shares but there is still a risk of challenge from the tax department at the lower levels.

CCDs – There are much stronger judicial precedents[7] that debentures cannot be equated with shares, and hence, this might prove to be a safer option for raising funds.

Tightening Valuations

Start-ups looking to go ahead with foreign investments while disregarding the risk of challenges from the tax department must look into the following safeguards for their valuations:

1. Maintain Robust Valuation Report
2. Backup projections based on underlying facts,
3. Using growth rates/ metrics that can be defended,
4. Realistic assumptions on revenue & costs,
5. Sanity check on Valuation Report Disclaimers,
6. Legal jurisprudence on valuation is fairly established in favor of the taxpayer on the ground that valuation by an expert cannot be challenged.[8]

CONCLUSION

The premise of angel tax was supposedly restricting the influx of 'black money' through capital markets. However, the same logic does not seem to be applied by tax authorities since 2012, as evinced by the continued strain of litigation on start-ups receiving funding through proper banking channels. With funds such as Sequoia and Blackstone having billions of dollars at their behest, does one really need a provision to confirm the creditworthiness and source of funds?

Section 56(2)(viib) might be outlasting its stated objective when Indian entrepreneurs are having to consider shifting HQs abroad. The Finance Ministry may need to rethink the new provisions, as the start-up industry which was hoping for a breather after the Covid shock, received a jolt themselves.

---

1. Notification No.29/2023 and No. 30/2023
2. https://www.giftgujarat.in/business/ifsc?tab=Tax%20Incentives
3. https://dpiit.gov.in/sites/default/files/FDI_Factsheet_March_23.pdf
4. F. No. 370142/9/2023-TPL(part-I), Notification dated May 26, 2023
5. Notification F. No. 370142/9/2023
6. [2018] 98 taxmann.com 299/173 ITD 200 (Mum)
7. Secure Meter Ltd. (CC 10548/2009), *Dy. CIT* v. *Modern Syntex India Ltd.*[2005] 3 SOT 27 (JP)
8. *G.L. Sultania* v. *SEBI* [2007] 76 SCL 473 (SC), *Dr. Mrs. Renuka Datla* v. *Solvay Pharmaceutical B.V.* [2004] 135 Taxman 200/265 ITR 435 (SC), *Miheer H. Mafatlal* v. *Mafatlal Industries Ltd.* [1996] 10 SCL 70 (SC), Duncans Industries Ltd. 2000 ECR 19 (SC)