argus partners
SOLICITORS AND ADVOCATES

November 8, 2023

Angel Tax and the (un)Ease of Doing Business in India

MUMBAI I DELHI I BENGALURU I KOLKATA

Table of Contents

I. Introduction 1
II. The Startup Exemption Challenge 1
III. The No-Startup Exemption Challenge 3
IV. Recent Transaction Experience and Possible Solutions 5
V. Impact on Ease of Doing Business 6

I. Introduction

The provisions relating to angel tax in the Income Tax Act, 1961 ("**IT Act**") were primarily introduced to regulate funding received by unlisted companies from angel investors and specifically, to curb money laundering and funnelling of black money into the start-up ecosystem.

Originally, under section 56(2)(viib) of the IT Act ("**angel tax provision**"), an unlisted company[1] receiving any consideration for issue of shares *exceeding the face value* of such shares *from any person being a resident*, the aggregate consideration received for such shares as exceeding the fair market value (determined in accordance with Rule 11UA of Income Tax Rules, 1962) ("**FMV**") was liable to tax in the hands of such company as 'income from other sources'. This provision, commonly referred to as 'angel tax', was inserted by the Finance Act, 2012 to prevent the circulation of unaccounted money as share premium. Since non-resident investors were always subject to pricing and other regulations under Indian exchange control laws ("**FEMA**"), investments by non-residents were initially kept out of the angel tax provisions.

While this provision was benign for a long time, the growing entrepreneurial spirit of young professionals in India coupled with rampant fund raising by start-ups led to an increased scrutiny by the Assessing Officers under the IT Act ("**AOs**") on income tax filings of these companies, including invocation of the angel tax provisions to question the (sometimes inflated) valuation of such companies.

In response, to ease the burden of angel tax on early-stage Indian companies, the Department for Promotion of Industry and Internal Trade ("**DPIIT**") issued a notification No. G.S.R. 127(E) dated February 19, 2019 ("**Start-up Notification**") exempting a star-tup (defined below) meeting specified conditions from the ambit of angel tax. While at first blush, this seemed like a business-friendly move, the devil, as always, lies in the detail.

As corporate transaction lawyers advising start-ups in various stages of evolution, we have had the opportunity to review the angel tax provisions and their impact on star-tup valuation and overall deal structuring. In this article, we aim to set out our observations on issues faced by start-ups and investors alike on account of the 'not so angelic' angel tax provisions and try to offer some practical suggestions to ease the fund raising process.

II. The Startup Exemption Challenge

Definition of Start-up

An entity incorporated as a private limited company, registered partnership firm or limited liability partnership is considered as a start-up up to a period of 10 years from the date of incorporation/ registration, if: (a) the turnover of the entity for any of the financial years since incorporation/ registration has not exceeded Rs. 100 crores; and (b) the 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. However, an entity formed by splitting up or reconstruction of an existing business is not considered a start-up.

There is some divergent jurisprudence on the interpretation of 'an entity formed by splitting up or reconstruction of an existing business', i.e., whether the condition applies only in the year of formation of the start-up or the condition needs to be evaluated in every year in which the entity seeks benefits as a start-up. The other issue is whether acquisition of intellectual property rights from another entity amounts to splitting up of an existing business. Given that most start-ups are in the technology sector, an interpretation which restricts transfer of intellectual property from previous entities to new start-ups could greatly impact the ability of the start-up to set up and scale its business.

[1] i.e., not being a company in which the public are substantially interested.

Eligibility of Startups to Claim Angel Tax Exemption

Additionally, to be eligible to claim exemption from angel tax, the aggregate amount of paid-up share capital and share premium of the start-up after issue or proposed issue should not exceed Rs. 25 crores[2] and the start-up should not invest in, *inter-alia,* the following:

(i) loans and advances, other than loans or advances extended in the ordinary course of business by the start-up where the lending of money is substantial part of its business;
(ii) capital contribution made to any other entity;
(iii) shares and securities.[3]

To qualify for the exemption, start-ups need to submit Form 2 to the Department for Promotion of Industry and Internal Trade ("**DPIIT**"), wherein they declare that they do not engage in acquiring the assets specified above. In case a start-up which has furnished this declaration undertakes such prohibited investments before the end of 7 years from the end of the latest financial year in which the shares are issued at a premium, the angel tax exemption would be revoked with retrospective effect.

The prohibition on investing in 'shares and securities' is so broad that industry experts have taken a view that even passive financial investments in mutual funds and related financial products to maximize a company's earning power could render a start-up ineligible to claim angel tax exemption. Further, given that the main objective of the start-up is to work towards innovation, development, scalability of the business model, employment generation and wealth creation, undertaking strategic acquisitions (of entities and assets) and diversifying the business through incorporating subsidiaries would be a critical requirement to achieve the stated objectives. Counterintuitively, undertaking these activities would make the start-up ineligible to claim exemption from angel tax, which reveals the façade of the supposedly business friendly 'start-up exemption' from angel tax.

Additionally, the restriction on loans and advances seems to also apply to loans and advances given by the start-up to its employees in the ordinary course of business, if the lending of money does not form a substantial part of such start-up's business. Given that loans and advances to employees is part of the day-to-day operations of a company, the Government's reluctance to provide a carve-out for such routine activities is baffling.

Practically, we have seen that companies in very early stages of inception (in the first 6 months to 1 year) are able to meaningfully comply with the conditions stipulated above and claim the start-up exemption from angel tax. Most other companies which are re-Series A/ Series A and upwards in the fund raising cycle, and companies in sectors such as defense, ed-tech, manufacturing, fin-tech, etc. which need to undertake strategic partnerships to scale the business, find themselves unable to claim exemption from angel tax, despite having a start-up registration.

---

[2] In computing the aggregate amount of paid-up share capital and share premium, shares issued to a non-resident, a venture capital company or a venture capital fund and a 'specific company' shall not be included.

[3] The other restricted investments are: (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) a motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds INR 10 Lakhs, 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; (d) jewelry other than that held by the startup as stock-in-trade in the ordinary course of business; and (e) any other asset, whether in the nature of capital asset or otherwise, of the nature specified in sub-clauses (iv) to (ix) of clause (d) of Explanation to clause (vii) of sub-section (2) of section 56 of the IT Act.

Resultantly, more often than not, companies raising funds in India need to comply with the angel tax provisions and FMV requirements under the IT Act.

III. The No-Startup Exemption Challenge

Extension of Angel Tax to Non-Resident Investors

To complicate matters further, the Government introduced the Finance Bill, 2023 under which the angel tax provisions were extended to investments by non-resident investors in Indian unlisted companies, with effect from April 1, 2024.[4]

Interestingly, the Finance Ministry, on May 24, 2023, notified 21 countries,[5] including the United States of America (USA), United Kingdom (UK) and France, from where non-resident investment in unlisted Indian entities will not attract angel tax. While the list is a step in the right direction, it does not include non-resident investors incorporated in Singapore, Mauritius, Netherlands and other countries which are active in the FDI space. Additionally, the exemption is available only to the following entities incorporated in these listed countries: (a) entities registered with Securities and Exchange Board of India ("**SEBI**") as Category-I Foreign Portfolio Investors; (b) endowment funds associated with a university, hospitals or charities; (c) pension funds created or established under the law of the foreign country or specified territory; and (d) broad based pooled investment vehicle or fund where the number of investors in such vehicle or fund is more than 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

The last condition creates further ambiguity since the Government has not specified the mode of counting the number of investors. A master fund could have many feeder funds and SPVs for its investments – which are legitimate under their respective regulations but may not satisfy the condition in (d) above. Additionally, the requirement of 50 investors may work for a mutual fund, but not Venture Capital ("**VC**") or Private Equity ("**PE**") funds, which are typically closely held.

Much like the garb of the 'startup exemption', the exemption of specified non-resident investors from the ambit of angel tax also fails to account for market realities and practicalities in scenarios where Series A to Series D funding rounds are supported by non-resident SPVs, VC or PE funds.

The Valuation Game under FEMA and IT Act

India is perhaps the only country where for one funding of a company, three separate reports by three separate entities are filed with three separate regulators — registered valuer report with the Ministry of Corporate Affairs (MCA), merchant banker report under the IT Act and chartered account/ merchant banker report with the Reserve Bank of India under FEMA.

The challenge arises on account of the diametrically opposite conceptions of fair market value under the IT Act and FEMA. Under FEMA, an Indian company cannot issue equity instruments[6] to non-resident investors below FMV (to be determined in accordance with internationally accepted pricing methodology), which acts as a pricing floor. Additionally, in case of convertible equity instruments subscribed by the non-residents, the conversion price cannot be less than the FMV at the time of issuance of such instruments.

---

[4] The Memorandum Explaining the Provisions of the Finance Bill, 2023 issued by the Government of India has clarified that this refers to the assessment year 2024-25, i.e., financial year beginning April 1, 2023.

[5] Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom and United States of America.

[6] Equity Instruments under FEMA means equity shares; fully, compulsorily and mandatorily convertible debentures; fully, compulsorily and mandatorily convertible preference shares and share warrants issued by an Indian company.

Given the challenges with valuation of early-stage companies and the valuation restrictions under FEMA, non-resident investors prefer to subscribe to equity instruments at a premium, where the subscription prices are higher than the FMV. This ensures that the convertible equity instruments convert into a greater number of equity shares which comes in handy for valuation adjustments, anti-dilution protection in case of future down rounds, giving effect to liquidation preference, etc. This buffer allows for the protection of the economic rights and commercial interests of the non-resident investors.

Unfortunately, with the extension of angel tax to non-residents and categorization of the FMV as the pricing ceiling under the IT Act, any amount received in excess of the FMV would be taxed at approximately 30% as income in the hands of the investee company. As a result, the only option for a company to comply with FMV requirements under FEMA and the IT Act is to procure investment at the exact FMV of the shares.

Recent Amendments to Valuation of Companies for Angel Tax

Realizing the pitfalls of extending the angel tax provisions to non-resident investors, the Central Board for Direct Taxes (CBDT) issued a notification dated September 26, 2023 providing additional flexibilities in the FMV valuation rules for angel tax provisions ("**Amended Valuation Rules**"), such as:

1. **New Valuation Methods**

   The Amended Valuation Rules increase the number of prescribed valuation methods for the purpose of angel tax from the existing 2 methods (net asset value and discounted cash flow method) to 7 (including comparable company multiple method, probability weighted expected return method, option pricing method, milestone analysis method and replacement cost methods). This could provide investors and start-ups with more flexibility and hence, encourage the start-up ecosystem in India. However, the valuation needs to be time-bound, as the report from the merchant banker cannot be obtained more than 90 days before the date of the issue of shares.

2. **VC Funds/ AIFs**

   Another major characteristic of the Amended Valuation Rules is price matching for resident and non-resident investors with reference to investments by VCs or specified funds, including Category I and II AIFs registered with the SEBI. To illustrate, if a venture capital undertaking[7] receives a consideration of Rs. 50,000 from a venture capital company[8] for issue of 100 shares at the rate of Rs. 500 per share, then such an undertaking can issue 100 shares at this rate to any other investor (including a non-resident investor) within a period of 90 days before or after the receipt of consideration from venture capital company.

   One would hope that some non-resident investors which are active in the Indian FDI space may set up fund structures in India to avail the above concession and be exempt from the rigors of the angel tax provisions. However, this may also require the investee entity to have strong bargaining power to convince a non-resident investor to register as a category I or II AIF, since the tax liability will be on the investee entity only, and not on the investor.

---

[7] Means such domestic company whose shares are not listed in a recognized stock exchange in India and which is engaged in the business of generation or generation and distribution of electricity or any other form of power or engaged in the business of providing telecommunication services or in the business of developing, maintaining and operating any infrastructure facility or engaged in the manufacture or production of such articles or things (including computer software) as may be notified by the Central Government in this behalf.

[8] Means such company as has made investments by way of acquiring equity shares of venture capital undertakings in accordance with the prescribed guidelines.

3. Safe Harbor Variation

Further, the Amended Valuation Rules provide for a "safe harbor" clause, which allows for a 10% variation between the valuation price and issue price, to account for forex fluctuations, bidding processes and variations in other economic indicators, which may affect the valuation of the unquoted equity shares during multiple rounds of investment. This is a welcome insertion as it gives more breathing room to start-ups as well as investors by acknowledging the volatility of the fundraising process.

This would also take into account the buffer preferred by non-resident investors for valuation adjustments, anti-dilution, liquidation preference, etc. as discussed above.

IV. Recent Transaction Experience and Possible Solutions

Perhaps the biggest challenge posed by the angel tax provisions and their extension to non-resident investors is on structuring of fund-raising transactions which not only involve primary subscriptions but also secondary acquisitions from existing shareholders. These secondary transactions are critical to providing the incoming investors with the desired level of capitalization without excessively diluting promoters and existing investors and providing exits for early-stage angel investors to streamline the cap table. These secondary transactions are usually negotiated at a price lower than the primary subscription price, since the liquidation preference attached with the secondary shares may be lower (as they are usually linked to the acquisition price paid by the original subscribers) and are not typically backed by the full suite of business representations and indemnities from the company and promoters.

In such transactions where the secondary acquisition of shares by a non-resident investor from a resident shareholder is at a price which is lower than the primary subscription price of that round, the angel tax restrictions and valuation floor and ceiling dualities under FEMA and IT Act respectively pose significant challenges. This is because a non-resident investor acquiring shares from a resident shareholder cannot pay less than the FMV under FEMA, which means that the FMV has to be lower than or equal to the secondary acquisition price. If the primary transaction is negotiated at a higher valuation, like it usually is, the delta between the FMV and the primary price could be categorized as ‘income from other sources’ in the hands of the Indian company and subject to angel tax.

The safe harbor variation discussed above could definitely come in handy to structure transactions of this nature, but a 10% delta may not provide the desired flexibilities to structure both legs of the transactions in a manner that is commercially beneficial for all stakeholders involved.

One of the solutions devised to overcome the angel tax restrictions is to issue convertible equity instruments without any premium, at a high face value, or issue a larger number of convertible equity instruments at nominal face value, but convertible to a lesser number of equity shares. This is possible since a technical interpretation of Section 56(2)(viib) of the IT Act requires the consideration exceeding the face value of the shares to also exceed the FMV to be taxable. Accordingly, this approach generally nullifies or mitigates the tax exposure on such companies under the extant angel tax provisions.

However, such issuances may lead to additional costs to the investee company in terms of additional stamp duty and filing fees for increasing the authorised capital to accommodate the entire funding as face value. This often leads to game theory analysis by founders, pegging the risks of an upfront monetary outflow to the company from the funds received versus the potential of tax scrutiny and levy of angel tax with interest and penalties in the future. A higher paid-up capital could also lead to additional compliances under the Companies Act, 2013 (such as appointment of company secretary, etc.) which are applicable to companies whose paid-up capital exceeds a certain threshold.

Another way to mitigate the exposure, particularly with transactions involving both primary and secondary legs, is to ensure that different instruments with different sets of rights are acquired by the investors in each leg. This, coupled with the expanded set of valuation methodologies (which now includes option pricing method) could be used to have two sets of FMVs for the two sets of securities being acquired. Having said that, given the trigger-ready approach of AOs to issue angel tax notices to companies in India, valuers may pause to adopt innovate valuation approaches to provide comfort to the investors while walking the tightrope of the angel tax requirements.

Another option could be to invest through compulsorily convertible debentures ("**CCDs**"), which are categorized as equity instruments under FEMA but debt instruments under the Companies Act, 2013. Since CCDs do not form part of the share capital of a company until converted into shares, foreign investors can negotiate contractual protections re voting rights, liquidation preference, anti-dilution, etc. and such agreements are enforceable under law. However, foreign investors, particularly PE and VC funds having strict internal obligations to their limited partners, may have restrictions or conditions on investing in debentures over equity or preference shares. Further, while it appears that issuance of CCDs is not covered by the angel tax provisions, it remains open to differing interpretations and is not free from doubt.

V. Impact on Ease of Doing Business

The Government's focus on FDI and campaign on ease of doing business in India is common knowledge. In light of the issues and hurdles discussed above, risk averse foreign investors may continue to prefer externalized structures requiring Indian entrepreneurs to flip entities to reside and receive investments outside India, thereby undermining the entire play for ease of doing business in India.

While adding more valuation methods, keeping a certain class of non-resident investors outside the ambit of angel tax and price-matching features are positive steps to provide flexibility to companies in the fund-raising process, they do not solve the larger issue concerning angel tax. Arguably, all this tinkering has taken angel tax away from its originally stated purpose of regulating the flow of unaccounted money as share premium and has given rise to innovative lawyering and complex tax structuring of equity fund raising in India.

argus partners
SOLICITORS AND ADVOCATES

Contributed by:

Ankit Guha
Partner

Vallishree Chandra
Principal Associate

DISCLAIMER

This document is merely intended as an update and is merely for informational purposes. This document should not be construed as a legal opinion. No person should rely on the contents of this document without first obtaining advice from a qualified professional person. This document is contributed on the understanding that the Firm, its employees and consultants are not responsible for the results of any actions taken on the basis of information in this document, or for any error in or omission from this document. Further, the Firm, its employees and consultants, expressly disclaim all and any liability and responsibility to any person who reads this document in respect of anything, and of the consequences of anything, done or omitted to be done by such person in reliance, whether wholly or partially, upon the whole or any part of the content of this document. Without limiting the generality of the above, no author, consultant or the Firm shall have any responsibility for any act or omission of any other author, consultant or the Firm. This document does not and is not intended to constitute solicitation, invitation, advertisement or inducement of any sort whatsoever from us or any of our members to solicit any work, in any manner, whether directly or indirectly.

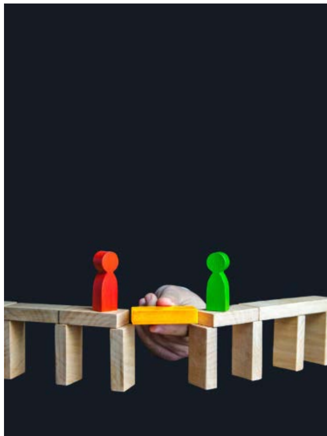
You can send us your comments at:

knowledgecentre@argus-p.com

Mumbai I Delhi I Bengaluru I Kolkata

www.argus-p.com

Recent Papers/ Articles



August 2023

The Exclusive Jurisdiction of Courts regarding Wills - Scope for arbitration/ mediation of disputes arising out of a Will

Disputes

July 2023

Green Hydrogen (Series 1) : Framework And Developments In India

Energy and Infrastructure

May 2023

Regulating AI

Technology and Data Privacy

May 2023

Navigating Crossroads Of IBC And RERA

Corporate Restructuring & Insolvency

May 2023

Is Online Rummy Chancier Than An Offline Round?

Technology and Data Privacy

April 2023

The Digital Personal Data Protection Bill, 2022 – An Analysis

Technology and Data Privacy

For more Papers/ Articles click here.

argus partners
SOLICITORS AND ADVOCATES

MUMBAI
11, Free Press House
215, Nariman Point
Mumbai 400021
T: +91 22 6736 2222

DELHI
Express Building
9-10, Bahadurshah Zafar Marg
New Delhi 110002
T: +91 11 2370 1284/5/7

DELHI
155, ESC House, 2nd floor,
Okhla Industrial Estate, Phase 3,
New Delhi – 110020
T: +91 11 45062522

KOLKATA
Binoy Bhavan
3rd Floor, 27B Camac Street
Kolkata 700016
T: +91 33 40650155/56

BENGALURU
68 Nandidurga Road
Jayamahal Extension
Bengaluru 560046
T: +91 80 46462300

www.argus-p.com I communications@argus-p.com