Angel taxation: Basis, design and critical view

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1. Introduction

Angel taxation refers to taxation of a portion of share premium received by an unlisted company. From the Financial Year 2012-13, if a closely-held company issues shares at a premium to a tax resident in India, the aggregate consideration received by the closely-held company in excess of the Fair Market Value (FMV) of the shares is subject to income tax as "income from other sources". Thus, a portion of capital contribution to a closely-held company is considered as "income" and is subject to income taxation.

The concept of taxing share premium is referred to as "Angel tax" in India since it impacted angel investments in unlisted companies. No country in the world imposes income tax on capital contribution. This provision was introduced in FY 2012-13 as a deterrent to the generation and use of unaccounted money, and to increase the onus of proof on closely-held companies for funds received from shareholders.

Angel tax does not apply to a "company in which the public are substantially interested", non-residents, a venture capital undertaking receiving the consideration for issue of shares from a venture capital fund or a specified fund or a venture capital company, and "start-ups" which qualify for the Angel tax exemption.

A "start-up" is not defined under the Income-tax Act in India but is described in notifications issued by the Income Tax Department (ITD) and the Department of Industrial Policy and Promotion (DIPP) under the Ministry of Commerce and Industry of the Government of India, now renamed as Department for Promotion of Industry and Internal Trade (DPIIT).

The definition of a start-up company, the process for being recognised as a start-up and the requirements to qualify for the Angel tax exemption have undergone multiple changes over the past 4 years, resulting in uncertainty for start-up companies.

As per the latest DPIIT notification issued on 19.02.2019, an entity shall be considered as a 'start-up'-

a) Up to 10 years from the date of its incorporation/registration, and

b) If its turnover for any of the FYs has not exceeded Rs. 100 crores, and

c) if it 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.

2. Requirements for Angel tax exemption:

2.1. The CBDT provides a blanket exemption from angel tax exemption only to DPIIT recognised start-ups if the aggregate amount of paid up share capital and share premium of the start-up after issue or proposed issue of shares does not exceed Rs. 25 crores. This amount excludes the share capital and share premium received from a non-resident, a venture capital company, a venture capital fund or a specified company.

2.2. The DPIIT has introduced some restrictions on the end-use of the funds raised, for a period of 7 years from the end of the latest Financial Year in which shares are issued at a premium.

2.3. The earlier requirement of an investor/proposed investor in a start-up having a minimum income or a net worth is removed completely.

The Finance Minister, Mrs. Nirmala Sitharaman proposed the following in her maiden Budget speech on 5th July 2019:

i). No scrutiny in respect of valuations of share premiums of start-ups and their investors who file requisite declarations and provide information in their returns.

ii). Establishing investor identity and source of funds will be resolved through e-verification. With this, no scrutiny from the IT Department on funds raised by start-ups.

iii). CBDT to make special administrative arrangements for pending assessments of start-ups and redressal of their grievances. No inquiry or verification in such cases can be carried out by the AO without obtaining approval of his supervisory officer.

iv). Exemption from justification of FMV of shares extended to Category-II Alternative Investment Funds also. Therefore, valuation of shares issued to these funds shall be beyond the scope of income tax scrutiny.

The Income-tax Rules, 1962 prescribes the methodology to determine the FMV of shares for purpose of Angel taxation. Under Rule 11UA (2),

- A company has an option to consider the higher of the FMV of unquoted shares determined under either of two methods –– Book value of Assets less Liabilities, or Discounted Free Cash Flow (DCF) method determined by a merchant banker.
- In addition, the company has an option to substantiate to the satisfaction of the Assessing Officer, the FMV of the shares based on the value on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature.

3. Consequences of Angel taxation:

3.1. All companies use the Discounted Cash Flow (DCF) as a *de facto* method to determine the value of a company at the time of fund raising, which is accepted by investors. This method is also approved under the Income-tax Rules, 1962 for determining the FMV of the company for Angel taxation.

The AOs contend that the FMV determined under the DCF method in many instances is unjustifiably high. But many investors, particularly institutional investors are willing to fund even loss-making companies at such high value using the same DCF method. The most contentious part of Angel taxation has been the unwillingness of the income-tax officers to accept the FMV determined under the DCF method when the law provides them with no choice for rejecting a valuation as per DCF method.

The concept of Angel tax implies that the FMV determined by a start-up which is acceptable to a willing investor is not ordinarily acceptable to the AOs in India unless it is justified to them. If not, they want to tax a portion of the capital received as "income".

3.2. Tussle between the AOs and the start-ups has resulted in litigation at various forums such as tribunals and high courts causing distraction for start-up entrepreneurs. They had to incur litigation costs and spend time on litigation instead of spending time on their business operations.

3.3. Angel taxation continues to haunt following companies:

- Companies that are not eligible to be recognised as a start-up
- Eligible companies that do not get recognised as a start-up
- Eligible companies that do not seek approval for Angel taxation exemption

3.4. Angel taxation hindered the entire process of capital raising by start-up companies.

3.5. Angel taxation results in payment of income tax at above 30%. Start-up companies are left with lower amount of capital to invest in their operations which is the primary purpose of raising capital. Alternatively, they are forced to raise more capital in order to pay income tax resulting in unnecessary dilution of share capital.

3.6. Many start-up companies relocated their capital raising entities outside India to escape from the rigors of Angel taxation.

4. Conclusion:

No country in the world imposes income tax on capital contribution. The problem of Angel taxation was the assumption that all closely-held companies issuing shares at a premium are facilitators of black money generation until they could demonstrate to the tax authorities that market value of the shares was fair.

The Income-tax department has not been able to unearth untaxed money through Angel taxation. In all the litigations before various Tribunals and High Courts relating to Angel taxation, the contention is not on the source of funding by the investors, but on the valuation of the company per se. Instead, it has only resulted in harassment of start-up entrepreneurs and investors in start-up companies relating to valuation of companies.

Angel taxation was unnecessary when there are other provisions in the Income-tax Act to identify and curb black money generation and circulation.

It would be best to withdraw Angel taxation since this provision continues to negatively affect companies that are not eligible to be recognised as a start-up, eligible companies that do not get recognised as a start-up and eligible companies that do not seek approval for Angel taxation exemption.