ANGEL TAX EXEMPTION GIVEN TO START-UPS

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ABSTRACT

In this paper, the author will analyse the current policy on the controversial "angel tax" exemption granted to start-ups. The paper will analyse the issues with Rule 11 UA that governs valuations of businesses. The paper will compare the old policy with the new policy and make suggestions on how the current policy can be improved. The paper will further discuss the problem of contradicting judgements in the area. Finally, the paper will connect it to the government of India's policies such as "Startup India", "Make in India" and "Aatmanirbhar Bharat".

Keywords: Angel Tax, DCF, NAV, Start-up India, Digital India, DPIIT.

WHAT IS "ANGEL TAX"?

The term finds its origin in section 56(2)(vii-b) of the Indian Income Tax Act, 1961 ("hereafter, "**the Act**"). Section 56 is the fifth head of income defined under the Act i.e. 'income from other sources'. Section 56(2)(vii-b) of the Act was introduced via an amendment in Finance Act, 2012, by the former Finance Minister, Shri. Pranab Mukherjee to counter the issue of black money in the economy[i]. As per this provision, companies receiving premium in excess of their 'fair market value' on issue of securities shall be taxed at 30% (Plus applicable surcharge and cess).[ii]

Therefore, the entire transaction is not taxed; rather, the difference between the fair market value and the issue price is taxed.

Chapter III-A of the SEBI (Alternate Investment Funds) Regulations, 2012 defines an angel fund and makes it mandatory for all angel funds in India to be registered with SEBI.[iii]

Conditions precedent for the applicability of section 56(2)(vii-b):

1. It applies only to closely held companies i.e. private companies.
2. Capital raised must be from a resident of India under the Act.
3. The capital raised from such fund/s must be against issue of securities.
4. The consideration received by the company must be in excess of the fair market value of the securities.

If the above-mentioned conditions are fulfilled, then this provision will be attracted.

The above mentioned conditions raise the pertinent question; how is the Fair Market Value (hereafter, "**FMV**") of these securities calculated. Section 56(2)(vii-b) read with Rule 11UA(2) provides the option to the assessee to opt for the Net Asset Value (hereafter, "**NAV**") method or the Discounted Cashflow (hereafter, "**DCF**") method carried on by a merchant banker.

HISTORY OF ANGEL TAX IN INDIA

The Department for Promotion of Industry and Internal Trade (hereafter, "**DPIIT**"), in an attempt to aid the start-up ecosystem in the country issued *Notification No. 501(E), on 23-05-*

2017.[iv] Its Notification No. 364(E) amended the 2017 notification, *on 11-04-2018.*[v] Notification No. 127(E) further amended the 2018 notification, *on 19-02-2019.*[vi] The following table will illustrate the change in policy over the 3-year period.

-	**Notification No. 501(E), 2017.**	**Notification No. 364(E), 2018.**	**Notification No. 127(E), 2019.**
Eligibility requirement	Innovation, development and improvement of products or processes or services and has scalable business model with high potential of employment generation or wealth creation.	Innovation, development and improvement of products or processes or services and has scalable business model with high potential of employment generation or wealth creation.	Innovation, development and improvement of products or processes or services and has scalable business model with high potential of employment generation or wealth creation.
Years of exemption u/s 56 and s. 80 IAC	7 years from incorporation. Exception: Biotech companies.	7 years from incorporation. Exception: Biotech companies.	10 years from date of incorporation.
Turnover limit	25 crores	25 crores	100 crores
Conditions	-	**1**. Paid up and Share premium collectively cannot exceed Rupees 10 crores. **2**. Net worth of the investor should be up to Rupees 2 crores. **Procedure**: Application to be filled in Form-2 and submitted to the	**1.** Paid up and Share premium collectively cannot exceed Rupees 25 crores, excluding money raised from VC's, Non-residents and public listed companies with a turnover greater than Rupees 250 crores or

		DPIIT for approval. DPIIT will then forward the application to the CBDT within 45 days and the CBDT upon its discretion may either reject or accept the application.	net worth of at least Rupees 100 crores in the last FY. **Procedure:** Self certified declaration to be filled in Form-2 with the DPIIT and the DPIIT will forward the application to the CBDT.
Restrictions on use of capital raised	-	-	Capital raised by the start-up cannot be utilized towards the following: **1.** Land or building being residential house other than that used for the purposes of renting. **2.** Loans and advances, if start-up isn't engaged in ordinary business of lending of money **3.** Capital contribution made to any other entity **4.** Shares and securities **5.** Motor vehicle, aircraft, yacht or any other mode of transport, if the cost of such an asset exceeds Rs. 10 lakhs.

			6. Jewellery **7.** Archaeological collections, drawings, paintings, sculptures, any work of art or bullion **8.** Any other capital asset. These restrictions are for a period of 7 years from the date of raising the capital. The above mentioned exceptions will not apply if held as stock-in-trade.

The Government of India has realized the importance of early stage investments to startups and has periodically been revising its policy to provide relaxations to and benefit startups in the Country and attempting to limit section 56(2)(vii-b) only to cases of wrong doing. Therefore, the logical question that then arises is, What is the problem? The problem lies in the details.

ISSUES WITH CURRENT POLICY

The exemption is not applicable to the issue of share with respect to which an assessing order has already been passed by the AO. There is no clarity on its applicability on assessees that have preferred an appeal against the order of the AO.

Further, no order, notification or other form of clarity on section 68 of the Act has been provided.[vii] Section 68 of the Act states, where any sum is credited into the books of accounts, for which the assessee is unable to provide an explanation to the satisfaction of the AO, such credited sum may be added to the total taxable income of the assessee. The proviso to section

68 applies to companies in which there is no significant public interest, this definition is applicable to startups as well. Under the proviso, any such sum credited by way of share application, share premium or any such amount by whatever name it may be called, a deeming provision has been created where the explanation offered to the AO shall be deemed unsatisfactory unless, the following conditions are fulfilled:

1. The resident in whose name the credit is recorded in the books of accounts of such company also offers an explanation about the nature and source of such money credited; and
2. Such explanation is to the satisfaction of the AO.

There is no clarity on the applicability of section 68 in cases of angel funding to startups. Therefore, the AO can still invoke section 68 and tax such transactions.

Issues with Notification No. 127(E) of 2019:

While the intent of the government behind the issue of the circular is laudable, some key issues do arise:

1. As mentioned above, no clarity on section 68 has been provided.
2. The increase of the turnover ceiling from Rupees 25 crores to Rupees 100 crores is a sigh of relief to the domestic startup ecosystem. Yet, Startups aiming to tackle bigger issues or startups with higher growth curves will not benefit from this notification. Profitability, in the author's opinion would serve as a much better metric on the basis of which exemptions are granted.
3. Investments received from AIF-1 and AIF-2 funds as categorized by SEBI are still ineligible for an exemption under the new policy.[viii]
4. Multiple restrictions have been placed on how these funds can be utilized. It is a standard industry practice to park such raised funds in liquid mutual funds till they are utilized. This practice is done because companies may not spend all the money immediately upon raising it and would exhaust it in phases on well thought through investments, in the meantime, it's a great idea to park these funds in liquid mutual funds and let the money earn some return. The most recent example of this is Reliance

Industries Limited, after the company went on a fund raising spree during the pandemic it parked this raised capital in liquid mutual funds.

5. Another problem with the restrictions prescribed mean companies cannot make contributions to any entity which would necessarily discourage or even disallow startups from having subsidiaries, especially for oversees expansion. The intent of these restriction are understood, however, instead of a blanket ban such contributions can be made with prior approvals from the revenue department. Moreover, the introduction of GAAR via chapter X-A already takes care of ingenuine transactions and therefore, these restrictions seem excessively limiting.
6. To be eligible for the exemption, the start-up has to be recognized by the DPIIT on the basis of the requirements laid down. Only 1-2% of the nation's start-ups are recognized by DPIIT leaving an overwhelming 98% of the start-up ecosystem still vulnerable to the angel tax.

Non-residents are exempt from angel tax:

Non-residents for the purposes of the Act have always been excluded from the applicability of section 56(2)(vii-b). Foreign funding goes tax free, while, domestic funding is taxed at 30 plus percent. As a result, angel funds not incorporated in India receive a competitive advantage over India's domestic industry and this has inevitably suffocated domestic funds. It should come as no surprise then that domestic angel funds are drying up. As per a report by *Inc42 Labs*, the number of seed funding deals was 642, this figure fell to 551 in 2017 and 331 in 2018.[ix] A partial reason of this can be attributed to the active income tax notices being sent to startups. For instance, the Income Tax department ("**IT** had without any notice deducted Rupees 1 crore from the bank accounts of 2 startups *Travelkhana* and *Babygogo*.[x] It also came to attention that the IT department had started collection angel tax against refunds of startups. Between 2014-2018, 38.5 Billion US Dollars were raised by Indian startups and an abysmal 10% of that came domestically.[xi]

As a result of this policy, Indian investors are being pushed out of the country to incorporate their angel funds in other countries to avoid the angel tax and by doing so, they are out of the purview of the SEBI AIF categories 1 and 2 funds Rules and are covered by FEMA and FDI laws. The current policy is detrimental to the economy, its pushing domestic entrepreneurs out of the country and with them, jobs, innovation, revenue by way of taxes and employment.

HOW DO YOU VALUE EARLY STAGE BUSINESSES?

Startups eligible for angel funding are very early stage businesses and therefore, have no assets or significant income. Therefore, access to initial funding is an absolute *sine qua non* for their survival. Since, early businesses have no assets or significant income, the NAV approach is unsuitable to value them. These startups are valued via the DCF method based on future cash projections, on the basis of the idea, the size of the addressable market and future potential.

Despite providing the assessee an option under Rule 11 UA(2) to opt for the NAV method or the DCF method, AO's are rejecting these methods even if they are done in line with the methods prescribed by the law and the guidelines laid down by the ICAI. There is no legal backing of the assessee in such cases where a method prescribed under the law has diligently been opted for by the assessee. The principal issue is that the revenue department is unable to understand how startups are valued.

CONTRADICTING JUDGEMENTS FURTHERING UNCERTAINTY

In *Rameshwaram Strong Glass Pvt. Ltd. v ITO*, the Hon'ble Jaipur ITAT held, where an assessee has determined FMV on issue of shares using the DCF method in line with the ICAI guidelines, the AO cannot change the method without a good justification for it. In *Agro Portfolio Pvt. Ltd.*, the Hon'ble Delhi bench of ITAT stated, the officer could change the method if the assessee fails to provide evidence to justify the said projections to the officer's satisfaction.

Further, startups that opted for the DCF method of valuation faced increased litigation. In *TUV Rheinland NIFE TUV Rheinland NIFE v. ITO,* the Hon'ble Bangalore bench of the ITAT upheld the right of the tax officer to reject the DCF method. In this case, the assessee had provided material to substantiate the valuation arrived at; however, it was not the satisfaction of the tax officer. The decision of the tax officer to recalculate the FMV and the final value arrived at by him was upheld by the CIT(A). In *M/s. Innoviti Payment Solutions Pvt. Ltd.* v. *ITO*, the Hon'ble Bangalore bench of the ITAT arrived at a different conclusion on a similar set of facts and stated, the assessee would have to substantiate the basis on which the valuation was arrived at to the satisfaction of the tax officer. If the tax officer is not satisfied, s/he may make additions and re-estimate the total taxable income but it would need to be done by the same method opted which was opted by the assessee. The Hon'ble bench also laid down guidelines on valuation methods. It stated, that only data and facts available should be used to analyse the valuation arrived and that no reliance should be placed on the actual results in the future and that the primary burden would be on the assessee to substantiate the valuation arrived at, given that the assessee would possess a special skill or knowledge with respect to the business and if the AO was not satisfied, a reason must be recorded only after which a fresh valuation report can be obtained.

However, *Agro Portfolio Pvt. V ITO*, the Delhi bench of the ITAT upheld the reasoning in the *Innoviti Payment Solutions Pvt. Ltd.* case and stated, in a situation where, the assessee has been unsuccessful in substantiating the valuation arrived at to the satisfaction of the tax officer, the tax officers may be forced to reject the DCF method and adopt the NAV method.

INDIA'S AMBITION OF BECOMING A GLOBAL START-UP HUB

India currently harbours the third highest number of start-ups globally.[xii] The Hon'ble Prime Minister has stated on national stage his ambition to make India a global start-up hub. This vision is well reflected with government initiatives like 'start-up India', 2016, 'make in India', 2014, 'digital India', 2015 and the Production Linked Incentives ("**PLI**"), 2020. These initiatives are commendable and ambitious; however, these goals cannot be achieved without changing domestic policies to create a stimulating start-up environment in the country. As per a report by NASSCOM, 70% of India's start-ups are going to run out of money in the near future.[xiii] This effect has only been exacerbated by the current pandemic that have left small businesses the most vulnerable. The importance of start-ups to a country are immense, they are vital to innovation, development of technology, creation of jobs, creation of world class businesses, and a bright future for people in the long run by pushing a majority of our under poverty population to the middle class. If we do not remedy the situation soon, we would *ipso facto* not realise our ambitions but also lose our title of having the third largest number of start-ups.

ENDNOTES

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