

Angel tax on non-resident investments: Safe harbour provisions and draft valuation rules introduced

As per Section 56(2)(viib) of the Income-tax Act, 1961 (“**IT Act**”), where any company (not being a ‘company in which the public are substantially interested’¹) receives ‘any consideration’ for issuance of shares from a person exceeding the face value of such share, the difference between the aggregate consideration received for issuance of such shares and the ‘fair market value’ (“**Tax FMV**”) of such share is chargeable to income tax in the hands of the company under the head ‘Income from other sources’.

This charge of income tax in the hands of the company receiving consideration for the issuance of shares is popularly referred to as the “**Angel Tax Provision**”.

The Tax FMV is the value higher of:

1. as determined in accordance with Rule 11UA(2) of the Income Tax Rules, 1962 (“**IT Rules**”); or
2. as may be substantiated by the company to the satisfaction of the Income Tax Authorities, 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.

As of today, Rule 11UA(2) of the IT Rules essentially provides 2 (two) mechanisms to compute the Tax FMV of unquoted equity shares as on the ‘valuation date’ at the option of the company receiving the consideration: (a) an adjusted Net Asset Value (“**NAV**”) methodology, or (b) Discounted Free Cash Flow (“**DCF**”) methodology as determined by a category I merchant banker registered with the Securities and Exchange Board of India (“**SEBI**”) (hereinafter referred to as the “**Merchant Banker**”). The term ‘valuation date’ means the date on which the consideration is received by the company issuing the shares.²

The Angel Tax Provision is not applicable where the consideration for issuance of shares is received by:

1. a ‘venture capital undertaking’³ from a ‘venture capital company’⁴ or a ‘venture capital fund’⁵ or a ‘specified fund’⁶;
or

¹ As defined in Section 2(18) of the IT Act.

² Rule 11U(j) of the IT Rules.

³ As defined in clause (c) of the Explanation clause to Section 10(23FB) of the IT Act.

⁴ As defined in clause (a) of the Explanation clause to Section 10(23FB) of the IT Act.

⁵ As defined in clause (b) of the Explanation clause to Section 10(23FB) of the IT Act.

⁶ A fund established or incorporated in India in the form of a trust/ company/ limited liability partnership/ body corporate which has been granted a certificate of registration as a category I or a category II alternative investment fund and is regulated under the SEBI (Alternative Investment Fund) Regulations, 2012 or regulated under the International Financial Services Centre Authority (Fund Management) Regulations, 2022 made under the International Financial Services Centres Authority Act, 2019;

2. a company from a class(es) of persons as may be notified by the central government (“**Exemption Power**”).

Pursuant to such Exemption Power, the central government had notified⁷ non-applicability of the Angel Tax Provision in case of receipt of consideration from tax residents in India by a company that fulfilled the specified conditions⁸:

- a) The company has been recognized as ‘Startup’ by the Department for Promotion of Industry and Internal Trade;
- b) The aggregate amount of paid-up share capital and share premium of the company after issuance or proposed issuance of shares does not exceed, INR 25,00,00,000⁹ (Indian Rupees twenty five crore); and
- c) The company has not invested in certain specified assets¹⁰

(Hereinafter (i),(ii) & (iii) collectively referred to as the “**Specified Conditions**”)

Until financial year (“**FY**”) 2022-23, the Angel Tax Provision was applicable only upon issuance of shares to tax residents in India. The Finance Act 2023 has expanded the Angel Tax Provision’s scope to include the issuance of shares to tax non-residents in India from FY 2023-24.

With the intention of providing relief and mitigating the negative impact of the expansion in the scope of the Angel Tax Provisions, the following changes in its application are made/proposed:

1. Pursuant to the Exemption Power, the central government has notified the non-applicability of the Angel Tax Provision:

- a) in case of receipt of consideration from any person (including tax residents and tax non-residents in India) by a company that fulfills the Specified Conditions.¹¹
- b) in case of receipt of consideration from the following class(es) of persons:¹²
 - i) Government and government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the government is 75% or more;
 - ii) Banks or entities involved in insurance business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident; or
 - iii) Any of the following entities, which is a resident of certain specified countries/territories and such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident:
 - Entities registered with the SEBI as category-I foreign portfolio investors;
 - Endowment funds associated with a university, hospitals or charities;
 - Pension funds created or established under the law of the foreign country or specified territory; or
 - Broad-based pooled investment vehicle or fund where the number of investors in such vehicle or fund is more than 50 (fifty) and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

The specified countries include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, UK, and USA.

⁷ Notification No. SO 1131(E), dated March 5, 2019.

⁸ Specified in para 4 of Notification No. G.S.R. 127(E) dated February 19, 2019 issued by the Ministry of Commerce and Industry in the Department for Promotion of Industry and Internal Trade

⁹ Certain entities have been exempted in computing this INR 25,00,00,000 (Indian Rupees twenty five crore) threshold.

¹⁰ The list of specified assets include capital contribution made to any other entity, shares and securities amongst others.

¹¹ Notification No. 30/2023/F. No. 370142/9/2023-TPL (Part-I)] dated May 24, 2023.

¹² Notification No. 29/2023/F. No. 370142/9/2023-TPL (Part-I) dated May 24, 2023.

2. Following amendments are proposed to Rule 11UA(2) of the IT Rules in computing Tax FMV of unquoted equity shares as on the 'valuation date':
- a) In case of receipt of consideration from a tax resident in India, the Tax FMV can be determined as per any of the following methods at the option of the company receiving the consideration:
 - i) An adjusted NAV methodology (hereinafter referred to as the "**Method A**");
 - ii) DCF methodology as determined by a Merchant Banker (hereinafter referred to as the "**Method B**");
 - iii) *where any consideration for issuance of shares is received by a 'venture capital undertaking' from a 'venture capital company' or a 'venture capital fund' or a 'specified fund':*
 Price of the equity shares corresponding to such consideration considered as Tax FMV (to the extent the consideration from such fair market value does not exceed the aggregate consideration that is received from a 'venture capital fund' or a 'venture capital company' or a 'specified fund')¹³ (hereinafter referred to as the "**Method C**"); or
 - iv) *where consideration is received by the company issuing the shares from any entity as notified pursuant to the Exemption Power ("**Notified Entity**"):*
 Price of the equity shares corresponding to such consideration as Tax FMV (to the extent the consideration from such fair market value does not exceed the aggregate consideration that is received from the Notified Entity)¹⁴ (hereinafter referred to as the "**Method E**").
 - b) In case of receipt of consideration from a tax non-resident in India the Tax FMV can be determined as per any of the following methods at the option of the company receiving the consideration:
 - i) Method A;
 - ii) Method B;
 - iii) Method C;
 - iv) fair market value of the unquoted equity shares determined by a Merchant Banker in accordance with any of the following methods:
 - Comparable Company Multiple Method;
 - Probability Weighted Expected Return Method;
 - Option Pricing Method;
 - Milestone Analysis Method; or
 - Replacement Cost Methods.
 (hereinafter referred to as the "**Method D**").
 - v) Method E
 - c) The date of the valuation report by the Merchant Banker is not more than 90 (ninety) days prior to the date of issuance of shares which are the subject matter of valuation can (at the option of the company issuing the shares) be deemed as the 'valuation date'.
 - d) Where the issue price of the shares exceeds the value of shares (determined as per below) by an amount not exceeding 10% of the valuation price, the issue price will be deemed to be the Tax FMV:

¹³ Subject to the receipt of consideration by the 'venture capital undertaking' from a 'venture capital company' or a 'venture capital fund' or a 'specified fund' within a period of 90 (ninety) days of the date of issuance of shares which are a subject matter of valuation.

¹⁴ Subject to the receipt of consideration by the company from the Notified Entity within a period of 90 (ninety) days of the date of issuance of shares which are a subject matter of valuation.

- i) In case of receipt of consideration from a tax resident in India: Determined as per Method A or Method B;
- ii) In case of receipt of consideration from a tax non-resident in India: Determined as per Method A, Method B or Method D.

Foreign exchange management challenges

Since the scope of Angel Tax Provision includes issuance of shares in India to non-residents from FY 2023-24, it will pose some concerns and challenges to foreign investors/investments unless they fall under one of the exceptions mentioned above.

Rule 21 of the Foreign Exchange Management (Non-debt Instruments) Rules, 2019, as amended, which deals with pricing of securities issued to person resident outside India, *inter alia*, provides that the price of equity instruments of an Indian company issued to a person resident outside India will not be less than :

- 1) the price worked out in accordance with the SEBI guidelines in case of a listed Indian company or in case of a company going through a delisting process as per the SEBI (Delisting of Equity Shares) Regulations, 2009;
- 2) the valuation of equity instruments done as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a chartered accountant or a merchant banker registered with the SEBI or a practicing cost accountant, in case of an unlisted Indian Company.

In certain foreign investment deals, specifically, private equity transactions, convertible securities are issued such as compulsorily convertible preference shares (CCPS) with conversion ratio. If securities are issued at a price higher than the price at which they are valued, the difference between the issue price and valuation price will be charged to Angel tax. Further, the difference between the issue price and valuation norm is generally used for adjusting the conversion ratio to give effect to provisions such as anti-dilution and certain corporate actions. Therefore, with this Angel Tax Provision, the foreign investment deals will have to be considered and structured from this perspective.

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