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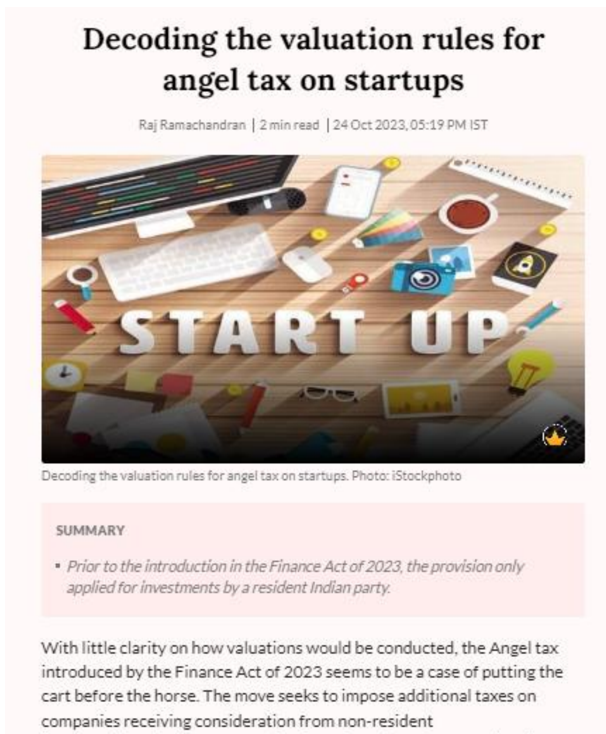
mint4-5 minutes 10/24/2023



Decoding the valuation rules for angel tax on startups

Raj Ramachandran | 2 min read | 24 Oct 2023, 05:19 PM IST

Decoding the valuation rules for angel tax on startups. Photo: iStockphoto

SUMMARY

- *Prior to the introduction in the Finance Act of 2023, the provision only applied for investments by a resident Indian party.*

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With little clarity on how valuations would be conducted, the Angel tax introduced by the Finance Act of 2023 seems to be a case of putting the cart before the horse. The move seeks to impose additional taxes on companies receiving consideration from non-resident investors/shareholders, surpassing the fair market value of unlisted shares.

Prior to the introduction in the Finance Act of 2023, the provision only applied for investments by a resident Indian party. The concerns around the entire principle behind the angel tax imposition aside, the provisions in the (Indian) Income Tax Rules have now been modified to clarify the valuation rules for the computation of fair market value and certain other matters.

These changes have been notified to come into effect from 25 September 2023. These rules and clarifications should help assess when, in what circumstances, and to what extent the premium over the fair market value would be subject to such angel tax.

While the angel tax provisions were notified in the Finance Act to be effective from 1 April 2023, the valuation rules have only been notified to be effective from 25 September 2023, and therefore the position on norms applicable for the intervening period remains unclear.

Additional valuation methodologies: Typically net asset value (NAV) method and the more popular discounted cash flow (DCF) method have been used for valuation for issuances of shares for resident investors and non-resident investors. The rules now permit five more valuation methods for non-resident investors, namely the comparable company multiple method, probability-weighted expected return method, option pricing method, milestone analysis method and replacement cost method.

Given the unique business models at play, the additional valuation methodologies may help issuer companies opt for a valuation methodology that is appropriate to their business activity. The intent behind introducing these additional valuation methods may also be to try and bridge the gap between valuation for tax and foreign exchange law purposes.

However, the manner in which the fair value determined, pursuant to such additional valuation methodologies, will be examined remains to be seen. It would be interesting if there are instances of valuation for the purposes of tax being determined differently from the valuation for the purposes of compliance with foreign exchange regulations.

Benchmarking fair value with total consideration: Where a non-resident entity notified by the central government makes an investment, the price paid for equity shares corresponding to such consideration may be taken as the fair market value of the equity shares both for resident and non-resident investors.

However, to be eligible for the benefit of such benchmarked fair value, two conditions have been prescribed. Firstly, the consideration received pursuant to such fair market value is not more than the aggregate consideration received from the notified entity. Secondly, the consideration received pursuant to such fair market value is within 90 days before or after the date of issuance of shares.

To illustrate: (a) where investment has been received from a notified entity at a specific fair value (say INR 100 per share), such fair value (INR 100 per share) can apply to issuances as aforesaid within the 90-day window, and (b) where the total consideration received from the notified entity is INR 100,000,000, the total consideration received based on such benchmark value cannot exceed INR 100,000,000.

Benchmarking fair value with total consideration maybe with an intent to address possible scenarios around nominal benchmark value investments.

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