

Tax Hotline

June 02, 2023

ANGEL TAX – IMPACT ON FOREIGN INVESTMENT

- Government and government related investors exempt from applicability of angel tax
- Investment by Specified Entities resident of 21 notified countries (including USA, UK but excluding Singapore, Mauritius, Netherlands) exempted from applicability of angel tax
- 5 more valuation methods proposed for non-resident investors
- Price matching mechanism proposed as a valuation methodology likely to be redundant and may not be beneficial for investors
- Hurdles in implementation of liquidation preference and protection against anti-dilution

Investment by non-resident in unlisted Indian companies at a price more than the fair market value (“FMV”) was bought under the ambit of angel tax provisions by the Finance Act, 2023. Considering that investment by non-residents is governed by foreign exchange control laws, the aforesaid amendment raises several fundamental issues with respect to structuring of investments in India by such foreign investors.

The Central Board of Direct Taxes (“CBDT”) has released notifications specifying (i) class of persons investment from which would not attract angel tax provisions¹ (“**Exclusion Notification**”) and (ii) draft valuation rules containing price matching and safe harbor mechanisms for public comments² (“**Draft Valuation Notification**”). In addition, CBDT has released another notification extending the Startup Exemption (defined below) to investment received by non-residents as well.³ While the notifications are welcome, the relief provided may be applicable in limited cases.

BACKGROUND

Finance Act, 2012 introduced the infamous ‘angel tax’ under section 56(2)(viib) of the Income-tax Act, 1961 (“ITA”).

Angel tax was originally introduced to discourage shell companies and prevent circulation of black money.⁴ Angel tax is applicable on companies, in which public are not substantially interested, on the receipt of consideration for the issuance of shares in excess of the FMV the shares of such company. The excess consideration received by such Indian companies is taxable as income from other sources. However, till March 31, 2023, this was limited to investments received from residents of India.

Angel tax provisions are not applicable in case where consideration for issuance of shares is received by:

1. A venture capital undertaking⁵ (“VCU” or “Unlisted Company”) from venture capital company⁶ (“VCC”) or venture capital fund⁷ (“VCF”) or a Category I or Category II alternative investment fund (“AIF”) registered with the Securities and Exchange Board of India (“SEBI”) or regulated under the International Financial Services Centres Authority Act, 2019 (“IFSCA Act”) (this will include an AIF set up in the International Financial Services Centres (“IFSC”);
2. A company or class of persons notified by the Central Government in this behalf.

In exercise with powers under section 56(2)(viib), CBDT had notified⁸ that angel tax provisions are not applicable in case where consideration for issuance of shares is received by an entity fulfilling the following conditions (“**Startup Exemption**”):

- It is recognized by the Department for Promotion of Industry and Internal Trade (“DPIIT”)⁹;
- Aggregate amount of paid-up share capital and share premium of the start-up post issuance of shares does not exceed INR 25 crores (~USD 3 million);¹⁰
- It has not invested and shall not invest in certain specified assets¹¹ for a period of 7 years from end of financial year in which shares are issued at premium¹²; and
- Files a specified declaration.

The aforesaid notification has limited applicability upto investment till USD 3 million.

Exclusion Notification

In exercise of powers under section 56(2)(viib), CBDT via the Exclusion Notification has provided that angel tax

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provisions will not be applicable in case where consideration for issuance of shares is received from the following classes of persons:

1. Government and Government related investors such as central banks, sovereign wealth funds (“SWFs”), 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;
2. Banks or entities involved in insurance business where such entity is subject to applicable regulations in home jurisdiction;
3. Any of the following entities, which is a resident of any specified country (21 countries notified) and such entity is subject to applicable regulations in home jurisdiction (“Specified Entities”):
 - Entities registered with SEBI as Category-I Foreign Portfolio Investors (“FPIs”);
 - Endowment funds associated with a university, hospitals or charities;
 - Pension funds created or established under the law of the foreign country or specified territory;
 - Broad based pooled investment vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

Draft Valuation Notification

Currently, the manner of computation of FMV of shares is prescribed under Rule 11UA of the Income-tax Rules, 1962 (“ITR”). Rule 11UA(2) allows a taxpayer to value unquoted equity shares of a company either on the basis of the net asset value (“NAV”) per share, or by way of the discounted cash flow (“DCF”) method, determined by a merchant banker. To the extent, the investment is made at FMV determined on DCF or NAV basis, angel tax provisions do not apply. Courts have held that the choice of adopting a valuation method under Rule 11UA is with the taxpayer and tax authorities cannot change or challenge the valuation method adopted by the taxpayer.¹³

Importantly, in case where investment is made at a price higher than FMV determined as per prescribed methods, the value has to be substantiated by the investee company to the income-tax authorities on basis of its assets, including intangible assets.

The Draft Valuation Notification seeks to amend Rule 11UA of the ITR. It provides that the FMV of unquoted equity shares for purpose of section 56(2)(viib) will be computed on the valuation date¹⁴ as follows:

1. For resident investors: on basis of NAV or DCF method, at the option of the Indian company receiving investment
2. For non-resident investors: on basis of NAV or DCF methods or additional methods like comparable company multiple method, probability weighted expected return method, option pricing method, milestone analysis method and replacement cost method, at the option of the Indian company receiving investment

In addition, a price matching mechanism has been provided. The Draft Valuation Notification provides that where any consideration is received by an Unlisted Company for issue of shares, from any non-resident entity specified in the Exclusion Notification, the price of the equity shares corresponding to such consideration may be taken as FMV of such equity shares for resident and non-resident investors subject to the following:

1. To the extent, the consideration from such FMV does not exceed the aggregate consideration that is received from the notified entity; and
2. The consideration has been received by the company from the notified entity within a period of 90 days of the date of issue of shares which are subject matter of valuation.

Price matching for resident and non-resident investors has also been specified in case where the Unlisted Company receives investment from VCC or VCF or specified AIF.

It has been proposed that valuation report by the merchant banker for the purpose of Rule 11UA will be acceptable if it is of a date not more than 90 days prior to the date of issue of shares which are subject matter of valuation.

In case where the issue price of shares is more than the FMV of shares determined in accordance with the Draft Valuation Notification, a 10% safe harbor is provided in case where FMV is determined (i) on NAV or DCF basis in case of resident investors or (ii) on NAV or DCF basis or on basis of any additional methods prescribed. Safe harbor is not available in case FMV is determined through price matching mechanism.

Public comments on the Draft Valuation Notification have to be provided by June 5, 2023.

Impact on foreign investment

- *Investment by government or government related investors (including SWF) or bank and insurance entities:* The exclusion of investments made by government related investors including SWFs, banks and insurance entities from angel tax provisions is welcome. Pertinent to note investments by government related investors including SWFs, banks and insurance entities continue to remain exempted from angel tax provisions irrespective of the jurisdiction from which such investments are made. Entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more are also included in the exemption list. Thus, where investment is being made by a special purpose vehicle (“SPV”) with direct or indirect ownership of Government, such investments will also not attract angel tax provisions.
- *Investment by Specified Entities:* Specified Entities includes entities which are resident of the 21 countries notified by CBDT. These countries inter-alia include Australia, France, Italy, Japan, United Kingdom, United States. Surprisingly, countries like Mauritius, Singapore, Netherlands, UAE from which India receives more than 50% foreign direct investment¹⁵ (“FDI”) has not been included in the list. This implies that investment made by Category-I FPIs, pension funds or investment funds from jurisdictions like Mauritius, Singapore, Netherlands, UAE etc. will be subject to angel tax provisions. This may discourage foreign investments from these intermediate jurisdictions.

Investment funds are established in jurisdictions like Singapore, Mauritius, Netherlands, Luxembourg due to favorable regulatory regime and appropriate infrastructure. These jurisdictions are signatory to the International Organization of Securities Commission's Multilateral Memorandum of Understanding and are not included in the Financial Action Task Force ("FATF") grey list or black list. Entities investing through these jurisdictions should also have been excluded from the ambit of angel tax provisions. While the exclusions are welcome and should bring clarity to certain set of investors, the scope of Specified Entities significantly limits the benefit of the exclusions.

- **Investment by Category-I FPIs:** Category-I FPIs inter-alia include Government and Government related investors, pension funds and university funds, appropriately regulated entities, entities from FATF countries and entities whose investment manager is from FATF member country. Considering that Category-I FPIs consist of government investors and investors from FATF jurisdictions, investments by Category-I FPIs (irrespective of the jurisdiction of investment) should have been exempted from angel tax provisions.

Further, Category-I FPIs typically invest in listed securities under the FPI route. To this extent, exclusion of investments by Category-I FPIs from angel tax seems irrelevant. It is possible for Category-I FPIs to invest in unlisted Indian companies under the FDI route. While the Exclusion Notification is silent on the route of investment, it may be possible to argue that investment by Category-I FPIs established in the specified jurisdictions under the FDI route may be exempt from angel tax provisions. In case where FPIs have made investment in unlisted shares under the FDI route, we have seen cases where the same FPI entity was unable to participate in an offer for sale by an Indian company going public. In such cases, FPIs had to restructure their FDI investments often resulting in adverse tax implications.

- **Investment by broad based investment funds:** Investment by investment funds with 50 or more investors have been exempted from applicability of angel tax provisions. It seems that the number of investors have to counted at the level of the investment fund and not on a look through basis. Typically, investors invest through a feeder vehicle for several reasons and the feeder vehicle pools into a master fund which ultimately invests in portfolio companies. The threshold of 50 investors is likely to limit the number of investment funds eligible to take benefit of this exemption. The concept of 'broad-based' funds¹⁶ seems to have been adopted from the erstwhile Securities and Exchange Board of India (Foreign Portfolio Investors) Regulations, 2014 which considered investors on a look through basis. While the concept of broad-based funds has been removed from the current FPI Regulations, the look through provision should have been provided in the Exclusion Notification.
- **Investment by AIFs (including AIF set up in IFSC):** Investment by Category-I or Category II AIFs registered with SEBI or regulated under the IFSCA Act is not subject to angel tax provisions. This is likely to make AIFs more attractive in India. Investors may also consider setting up captive AIF in IFSC for a single investment as well.
- **Investment alongwith an AIF or Specified Entities:** The price matching mechanism deems the FMV at which any VCC or VCF or specified AIF invests in an Unlisted Company to be the FMV for other resident investors as well. However, such deeming fiction is limited to the extent of investment made by the VCC or VCF or specified AIF in the Unlisted Company. For example, in case where a specified AIF subscribes to 1,000 equity shares of an Unlisted Company at FMV of INR 50 per share, the FMV for other resident investors will also be considered to be as INR 50 per share. However, this is limited to the amount invested by the specified AIF i.e. INR 50,000. In case where the resident investor is investing more than the amount invested by the specified AIF, FMV for such excess amount will have to be determined in accordance with Rule 11UA. A similar price matching mechanism has been proposed in case where Unlisted Company receives investment from any non-resident entity specified in the Exclusion Notification.

In addition, the Draft Valuation Notification provides investors to determine FMV as per the price matching mechanism in case investment is made within 90 days of date of issue of shares to such investor. Practically, considering that a new round will mostly likely not consummate in 90 days, this valuation methodology is likely to be redundant and investors may not be able to benefit from the price matching mechanism. In addition, from a FEMA valuation perspective, a report submitted by a merchant banker is typically valid for 90 days from the valuation date (i.e., the cut-off date basis which valuation has been determined and not the date specified under the valuation report), hence the price matching mechanism provided in the draft valuation rules is not likely to help a foreign investor.

- **Hurdles in implementation of liquidation preference and protection against anti-dilution:** It is very common for foreign investors to invest through CCPS. Interestingly, the Valuation Notification specifies the manner of determination of FMV of only unquoted equity shares. In case where an unlisted company is envisaging to raise funds by CCPS, Rule 11UA provides that FMV of CCPS shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of such valuation. Flexibilities like price matching mechanism, safe harbor etc. proposed by the Valuation Notification do not apply to investment in CCPS. This again limits the benefits granted by government with respect to angel tax provisions. Upon conversion of CCPS into equity shares, considering that the value of equity shares received is equivalent to the value of CCPS, it may be possible to argue that angel tax provisions will not apply on conversion.

Foreign exchange control laws require the conversion formula of CCPS to be determined upfront at time of issuance. It is further provides that the price at the time of conversion should not be lower than the fair value at time of issuance of CCPS. From a private equity and venture capital deal perspective, investment in CCPS is common as there is often a gap between how founder perceives the valuation of the company and how investors perceives the value of the company. To bridge this gap, investors often invest at a price higher than FMV but with balancing rights such as, anti-dilution rights, liquidation preferences, etc. In case of a down round or exit, an investor would exercise its anti-dilution right or liquidation preference right resulting in conversion of CCPS at a price lower than the investment price but higher than the FMV at time of investment. The change in angel tax provisions is likely to create issues in the negotiation of such rights at the time of fund raising by such Indian companies. This will make investment in Indian companies less attractive.

- **Investment by other foreign investors:** The flexibility provided by the Valuation Notification on valuation of unquoted equity shares is welcome. Non-resident investors have been given an option to choose from any of the 5 additional valuation methods prescribed. This should put to rest concerns of non-resident investors with respect of

valuation mismatch as per foreign exchange control rules and ITR.

In past, several startups have faced challenges in raising funds due to tax authorities challenging the valuation reports shared by the startups, despite, such valuation reports complying with Rule 11UA. While the flexibility in terms of prescribing different valuation methods is welcome, in order to maintain a conducive investment environment in India, it will be important that the tax authorities do not challenge valuation reports submitted by Indian companies.

- *Investment through compulsorily convertible debentures ("CCDs")*: Foreign investors may consider investment via CCDs. Such investment in CCDs may not attract angel tax provisions. While CCDs may not give investors voting rights in investee companies, the same may be achieved through separate contractual voting arrangements that may be entered between CCD holders and other shareholders of investee companies governing voting rights. Such agreements are enforceable under law but may put CCD holders on a lower footing as compared to subscribing to an equity / CCPS instrument. Further, investment in CCDs may not work for entities like non-banking financial companies which prefer to raise Tier-I capital. Interestingly, one may also take a view that transfer of CCDs is exempt from capital gains tax for the transferor in case of investments from Singapore or Mauritius, under the India -Singapore / India – Mauritius tax treaty, respectively.

CONCLUSION

While the changes proposed are a positive step and provides certain relief to industry, several larger issues with respect to angel tax still remain. There may be questions with respect to constitutional validity of Section 56(2)(viib). Such questions may arise inasmuch as the delegation of authority to the income tax authorities whereby they may replace share valuations arrived at through commercial negotiations, may be seen as being excessive and arbitrary. The tax on capital may also be viewed as being an unreasonable restriction of the right to carry on business, which is guaranteed under Article 19(1)(g) of the Constitution of India. In an environment where foreign investment in India has witnessed a drop, while effective implementation of the exclusions and valuations rules prescribed by government will be key to ensure inflow of foreign money, it is imperative that the government re-looks the tax policy on taxing capital investments.

– Ipsita Agarwalla, Basava Rao, Dr. Dhruv Janssen-Sanghavi, & Parul Jain

You can direct your queries or comments to the authors

¹Notification dated May 24, 2023

²F. No. 370142/9/2023-TPL(part-I), Notification dated May 26, 2023

³S.O. 2275(E) dated May 24, 2023

⁴Budget Speech, available at: [Tax Laws & Rules > Finance Bill \(incometaxindia.gov.in\)](https://www.incometaxindia.gov.in)

⁵A VCU has been defined to mean (i) as per SEBI (Alternative Investment Funds) Regulations, 2012 a domestic company which is unlisted at the time of making investments; or (ii) as per SEBI (Venture Capital Funds) Regulations, 1996 an unlisted domestic company engaged in the business of providing services or production / manufacture of articles or things, excluding the activities or sectors provided in the negative list

⁶A VCC has been defined to mean an unlisted company, which, inter alia, has been granted a certificate of registration as VCF as a sub-category of Category I AIF and is regulated under the SEBI (Alternative Investment Funds) Regulations, 2012, and which fulfils the following conditions (i) It has invested not less than two-thirds of its investible funds in unlisted equity shares or equity linked instruments of VCU; and (ii) It does not have any investments in a VCU in which its director or a substantial shareholder (being a beneficial owner of equity shares exceeding 10% of its equity share capital) holds, either individually or collectively, equity shares in excess of 15% of the paid-up equity share capital of such VCU

⁷A VCF means a fund which is either a trust registered under the provisions of the Registration Act, 1908 or operating vide a scheme by Unit Trust of India under the Unit Trust of India Act, 1963. Where it is a registered trust, it must be granted a certificate of registration as VCF as a sub-category of Category I AIF under the SEBI (Alternative Investment Funds) Regulations, 2012 and which fulfils the following conditions (i) It has invested not less than two-thirds of its investible funds in unlisted equity shares or equity linked instruments of VCU; (ii) It has not invested in any VCU in which its trustee or the settler holds, either individually or collectively, equity shares in excess of 15% of the paid-up equity share capital of such VCU; and (iii) The units, if any, issued by it are unlisted

⁸Notification dated March 5, 2019

⁹An entity is considered as a startup by DPIIT (i) upto a period of 10 years from its incorporation as a company or limited liability partnership or partnership firm; (ii) turnover of the entity for any financial year since incorporation has not exceeded INR 100 crores (~USD 12 million); (iii) 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

¹⁰Amount invested by a non-resident or VCC or VCF is not considered in computing the aggregated amount of paid up share capital and securities premium

¹¹For example, shares and securities, capital contribution to any other entity etc.

¹²In case where a startup fails to fulfill this conditions and invests in a specified asset before end of 7 years from the end of the latest financial year in which the shares are issued at premium, the exemption provided under section 56(2)(viib) is revoked with retrospective effect

¹³Vodafone M-Pesa Ltd. v PCIT (2018) 164 DTR 257 (Bom)(HC); CIT vs Credtalpa- (2022) 94 ITR (T) 596 (Mumbai-Trib); Crown Chemicals Private Limited vs ACIT (ITA No.7876/Mum/2019)

¹⁴As per Rule 11U of the ITR, "Valuation Date" means the date on which the consideration is received by the assessee

¹⁵https://dpiit.gov.in/sites/default/files/FDI_Fact_sheet_D ecember_ 2022.pdf

¹⁶The erstwhile FPI Regulations defined "broad-based fund" to mean a fund, established or incorporated outside India, which has at least twenty investors, with no investor holding more than forty-nine per cent of the shares or units of the fund: Provided that if the broad-based fund has an institutional investor who holds more than 49% of the shares or units in the fund, then such institutional investor must itself be a broad based fund

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