

# EY Tax Alert

## CBDT issues draft valuation rules for angel tax provisions for public consultation

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### Executive summary

This Tax Alert explains the public consultation document issued by the Central Board of Direct Taxes (CBDT)<sup>1</sup> which proposes to amend valuation rules relevant for “angel tax” provisions.

The Finance Act 2023 amended Section 56(2)(viib) of the Income tax Act 1961, which taxes excessive premium received by a closely held company (CHC) from a resident (popularly known as “angel tax” provision) to include share investment made by a non-resident (NR), with effect from tax year 2023-24. The stakeholders raised concerns on increase in valuation disputes due to such an amendment. In response to such concerns, the CBDT announced a slew of reliefs from “angel tax” vide Press Release dated 19 May 2023<sup>2</sup>. The CBDT also issued two Notifications on 24 May 2023<sup>3</sup> as announced in the Press Release for (a) notifying the class of NR investors whose investment shall be excluded from “angel tax” and (b) extending the current reliefs for investment by residents in start-ups registered with DPIIT<sup>4</sup> to NR investors.

Following up on the announcement in Press Release regarding modification of valuation rule for computing Fair Market Value (FMV), the CBDT has now issued draft of amended Rule 11UA for public comments.

<sup>1</sup> The apex body for administration of direct taxes in India

<sup>2</sup> Refer EY Flash News dated 22 May 2023, titled “CBDT proposes relief from angel tax pursuant to Budget 2023 amendment expanding scope to non-resident investment”

<sup>3</sup> Refer EY Tax Alert dated 26 May 2023, titled “CBDT notifies specified class of investors and start-up companies exempt from angel tax provisions”

<sup>4</sup> Department for Promotion of Industry and Internal Trade

The existing Rule 11UA prescribes two methods (viz. NAV<sup>5</sup> or DCF<sup>6</sup>) for determining the FMV of equity shares issued to resident investors. The CBDT proposes to include five more valuation methods for issue of equity shares to NR investors viz. Comparable Company Multiple Method, Probability Weighted Expected Return Method, Option Pricing Method, Milestone Analysis Method and Replacement Cost Methods.

Furthermore, it proposes to introduce price matching facility for both resident and NR investors. In terms of such price matching facility, the price at which equity shares are issued by CHC to notified NR entities shall be adopted as FMV for the purposes of benchmarking equity investments by both resident and NR investors, subject to compliance of certain conditions.

Existing Rule 11UA requires merchant banker DCF valuation report as on the date of issue of shares. The CBDT proposes to provide flexibility by making valuation report issued up to 90 days prior to the date of issue of equity shares acceptable for computing FMV for investments by both resident and NR investors.

Lastly, in order to factor in the variation in price due to various factors, the CBDT proposes to introduce safe harbor limit of 10% for valuation of equity shares which can be availed by both resident and NR investors.

The CBDT has sought public comments on the above referred draft of amended Rule 11UA by 5 June 2023.

## Background

- ▶ Section 56(2)(viib) (popularly known as the “angel tax” provision) is an anti-abuse provision which applies when a CHC issues shares (including preference shares) at a premium and receives consideration which is in excess of the FMV of the shares. The excess amount so received is deemed as income from other sources in the hands of the CHC in the year of issue of the shares. However, investments by venture capital funds (VCFs) in venture capital undertaking are exempted from angel tax.
- ▶ Rule 11UA of the Income Tax Rules<sup>7</sup> prescribes the valuation methodology for determining the FMV of various types of assets (including unquoted equity shares), not only for the purposes of the angel tax provision, but also for other anti-abuse provisions involving transfer of assets without consideration or at a value less than the FMV.
- ▶ The FMV of unquoted equity shares for the purpose of the angel tax provision read with existing Rule 11UA is the higher of the following:
  - ▶ Net asset value as reflected in the audited balance sheet of the CHC (NAV method); or
  - ▶ The Discounted Cash Flow (DCF) value as determined by a Category-I Merchant banker (DCF method); or
  - ▶ The value that the CHC is able to substantiate to the satisfaction of the tax authority, basis the holding of various intellectual property rights (IPRs) like goodwill, know-how, patents, copyrights, etc.
- ▶ Rule 11UA prescribes valuation of preference share at a price it would fetch if sold in the open market on the valuation date and the CHC may obtain a report from a merchant banker or an accountant in respect of such valuation.
- ▶ Prior to amendment by the Finance Act 2023 (FA 2023), the angel tax applied only to shares issued to a resident. FA 2023 amended the angel-tax provisions, with effect from tax year 2023-24, to extend it to issue of shares by a CHC to NR investor. FA 2023 also extended the exemption from angel tax to investments in CHC by VCFs set up in IFSC<sup>8</sup> (specified funds).
- ▶ The expansion of angel tax provisions gave rise to concerns regarding trigger of angel tax and valuation disputes on investments made by genuine and regulated NR investors in Indian companies (including start-ups registered with DPIIT).
- ▶ In response to such concerns, the CBDT issued a Press Release on 19 May 2023 announcing a slew of reliefs from “angel tax”.
- ▶ Pursuant to the above, on 24 May 2023, CBDT issued Notification Nos. 29 and 30 of 2023<sup>9</sup> which prescribe as under:
  - ▶ Notification No. 29/2023 (effective from 24 May 2023) enlists categories of persons whose investments in CHC shall not be subject to trigger of angel tax provisions like (i) Government and Government related investors, (ii) banks or regulated entities involved in insurance business and (iii) investors resident in any of the 21 jurisdictions and regulated in the country where it is established, incorporated or resident like category-I foreign portfolio investors, endowment funds, pension funds and broad-based pooled investment vehicles or funds.
  - ▶ Notification No. 30/2023 (effective retrospectively from 1 April 2023) exempts start-up companies from the angel tax provision if the start-up company fulfils the conditions specified by DPIIT in para 4 of its Notification No. G.S.R 127(E) dated 19 February 2019 and files a self-declaration to that effect. The exemption is applicable where a start-up company issue shares for a consideration at a premium to any person (whether resident or NR).

<sup>5</sup> Net Asset Value method

<sup>6</sup> Discounted Cash Flow method

<sup>7</sup> Income-tax Act, 1961 r.w. Income-tax Rules, 1962

<sup>8</sup> International Financial Services Centre

<sup>9</sup> Refer EY Tax Alert dated 26 May 2023 titled “CBDT notifies specified class of investors and start-up companies exempt from angel tax provisions”

- ▶ On 26 May 2023, the CBDT has issued the public consultation document which provides draft of amended Rule 11UA. The proposed amended Rule 11UA is aimed to prevent valuation disputes on investment by resident and NR investors in CHC. The CBDT has sought public comments within 10 days until 5 June 2023 on the proposed amended Rule 11UA.

## Proposed amendment to Rule 11UA

- ▶ **Effective date:** The proposed amended Rule 11UA shall be effective from the date of publication in Official Gazette. FA 2023 expanded the scope of angel tax provisions to cover NR investments from 1 April 2023, however, the rules are proposed to be applied from a later date.

- ▶ **Valuation methods:** The proposed amended Rule 11UA provides different valuation methods for equity shares issued to resident and NR investors. The resident and NR investors have option to select from any of the given valuation methods.

- ▶ The valuation methods for issue of unquoted equity shares shall continue to be NAV and DCF.

- ▶ Proposed amended Rule 11UA provides five new valuation methods in addition to existing NAV and DCF methods for equity share investments by NR investors. The five new methods are:

- (i) Comparable Company Multiple Method
- (ii) Probability Weighted Expected Return Method
- (iii) Option Pricing Method
- (iv) Milestone Analysis Method
- (v) Replacement Cost Methods

- ▶ **Price matching facility for both resident and NR investment:**

- ▶ The price at which equity shares are issued by CHC to NR entities notified in Notification No. 29/2023 shall be adopted as the FMV for the purposes of benchmarking equity investments by both resident and NR investors, subject to compliance of following conditions:
  - The consideration received from other investors at such FMV does not exceed aggregate consideration received from notified NR entity; and
  - Consideration is received by CHC from notified NR entity within a period of 90 days of the date of issue of shares which are the subject matter of valuation.

- ▶ Similar price matching facility shall also be available with respect to investment made by VCF/venture capital company and specified funds in venture capital undertakings.

- ▶ However, there is a contradiction in the reckoning of the window period of 90 days in the text of the proposed amended Rule 11UA in relation to investment made by VCF and specified funds and illustration provided therein.

- ▶ As per text of the proposed amended Rule 11UA, the investment by VCF should be within a period of 90 days of the date of issue of shares which are the subject matter of valuation. But the illustration states that the shares, which are the subject matter of valuation, should be issued within a period of 90 days of receipt of consideration received from VCC. This creates confusion whether the share investment which is the subject matter of valuation should precede or succeed the investment by excluded NR.

- ▶ **90 days window period for merchant banker valuation**

- ▶ Existing Rule 11UA requires merchant banker DCF valuation report as on the date of issue of shares.
- ▶ The proposed amended Rule 11UA provides flexibility by making the valuation report issued up to 90 days prior to the date of issue of equity shares acceptable for computing FMV for investments by both resident and NR investors.

- ▶ **Safe harbor valuation tolerance limit of 10%**

- ▶ Existing angel tax provision and Rule 11UA do not provide for any safe harbor valuation tolerance limit.
- ▶ The proposed amended Rule 11UA provides a tolerance limit of 10% for both resident and NR investors.
  - In case of resident investor, if the issue price for equity shares is within 10% of price determined as per NAV and DCF method, then such issue price shall be deemed to be FMV.
  - In case of NR investor, if the issue price for equity shares is within 10% of price determined as per NAV or DCF or any of the five new methods, then such issue price shall be deemed to be FMV.

- ▶ As per Press Release, the safe harbor is intended to factor in the variations due to forex fluctuations, bidding processes, other economic indicators, etc. which may affect the valuation of the unquoted equity shares during multiple rounds of investment.

► **No change in valuation of preference shares**

- There is no amendment proposed to the valuation of preference shares issued to resident and NR investors.
- Accordingly, the following reliefs, as proposed to be provided for the valuation of equity shares, shall not be available for valuation of preference shares:
  - Price matching facility
  - Flexibility of validity of valuation by merchant banker up to 90 days
  - Safe harbor of 10%

## Comments

The CBDT has commendably adopted a consultative approach in determining valuation to be adopted for computing FMV of equity shares for the purposes of “angel tax”. The proposed amended Rule 11UA is largely in line with elements announced vide Press Release dated 19 May 2023. Stakeholders need to offer their comments by 5 June 2023 by email to [ustpl2@nic.in](mailto:ustpl2@nic.in)

The possible issues for stakeholders to consider making further representations are, briefly, as follows:

Whether the five new methods of valuation of equity shares ought to be extended to resident investments also?

Whether the window period of price matching facility should be expanded to investment prior and post investment by notified NR investor by clearing the confusion arising in the text and illustration provided in the proposed amended Rule 11UA?

Whether the quantum of permissible investment by resident and NR investors in price matching facility ought to be enhanced from the proposed limit of consideration received from notified NR investors?

Whether the proposed amended Rule 11UA should be made retroactively applicable from 1 April 2023 to avoid any valuation dispute for investments made between 1 April 2023 to the date of Notification of amended Rule 11UA?

Whether the reliefs provided for valuation of equity shares should be extended to valuation of preference shares also?

Separately, stakeholders may also wish to seek expansion of the list of countries from which investors will not face angel tax issue and more categories of NR investors to be covered therein.

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