

EY Tax Alert

CBDT notifies new valuation rules for equity and compulsorily convertible preference shares for angel tax provisions

Executive summary

This Tax Alert explains the Notification¹ issued by Central Board of Direct of Taxes (CBDT)² dated 25 September 2023 which amends valuation rules relevant for “angel tax” provisions.

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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 certain amendments to valuation rules (i.e., Rule 11UA) vide Press Release dated 19 May 2023 and issued draft of amended Rule 11UA for public comments on 26 May 2023.

Post public consultation, the CBDT has now notified the final amended Rule 11UA with effect from 25 September 2023. The salient features of the amended Rule 11UA are as under:

- ▶ The amended Rule 11UA provides separate valuation mechanism for compulsorily convertible preference shares (CCPS) and also provides an option to adopt fair market value (FMV) of unquoted equity shares for determining FMV of CCPS.
- ▶ The erstwhile Rule 11UA prescribed two methods (viz. NAV³ or DCF⁴) for determining the FMV of equity shares issued to resident investors. The amended Rule 11UA provides five more methods of valuation for issue of unquoted equity shares or CCPS to NR investors viz. Comparable Company Multiple Method, Probability Weighted Expected Return Method, Option Pricing Method, Milestone Analysis Method and Replacement Cost Methods.

¹ CBDT Notification No. 81/ 2023

² The apex body for administration of direct taxes in India

³ Net asset value method

⁴ Discounted Free Cash Flow method

- ▶ The price matching facility as per draft rules for both resident and NR investors is extended to CCPS. In terms of such price matching facility, the price at which unquoted equity shares or CCPS are issued by CHC to notified NR entities/ venture capital funds (VCF)/ specified funds shall be adopted as FMV for the purposes of benchmarking equity and CCPS investments by both resident and NR investors, subject to compliance of certain conditions.
- ▶ In relation to price matching facility, price at which shares are issued to notified NR entities/ venture capital funds (VCF)/ specified funds shall be adopted as FMV, if receipt of consideration is within a window of 90 days before or after the date of issuance of shares subjected to valuation.
- ▶ The erstwhile Rule 11UA required merchant banker DCF valuation report as on the date of issue of shares. The amended Rule 11UA provides flexibility by making valuation report issued up to 90 days prior to the date of issue of equity shares or CCPS for computing FMV for investments by both resident and NR investors.
- ▶ Lastly, amended Rule 11UA introduces safe harbor limit of 10% for valuation of equity shares and CCPS for both resident and NR investments.
- ▶ 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 company 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.
- ▶ Prior to the Notification, Rule 11UA prescribed valuation of preference share at a price it would fetch if sold in the open market on the valuation date (Open market value) and the CHC may obtain a report from a merchant banker or an accountant in respect of such valuation.
- ▶ Prior to the 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 IFSC⁶ (specified funds).

Background

- ▶ Section 56(2)(viib) of the ITL (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.
- ▶ Rule 11UA of the Income Tax Rules⁵ 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.
- ▶ Prior to Notification, the FMV of unquoted equity shares for the purpose of the angel tax provision read with earlier Rule 11UA was the higher of the following:
- ▶ 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 Department for Promotion of Industry and Internal Trade -DPIIT).
- ▶ In response to such concerns, the CBDT issued a Press Release on 19 May 2023 announcing a slew of reliefs from "angel tax" viz, amendment to valuation rules, excluding certain entities from the scope of angel tax provision and non-applicability of the provision to start-ups. Accordingly, the CBDT prescribed as under:
- ▶ Notification No. 29/2023 (effective from 24 May 2023)⁷ 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

⁵ Income-tax Act, 1961 r.w. Income-tax Rules, 1962

⁶ International Financial Services Centre

⁷ Refer EY Tax Alert titled "CBDT notifies specified class of investors and start-up companies exempt from angel tax provisions" dated 26 May 2023

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).
- ▶ On 26 May 2023, the CBDT issued a public consultation document providing a draft of amended Rule 11UA. The proposed amended Rule 11UA was aimed to prevent valuation disputes on investment by resident and NR investors in CHC⁸.
- ▶ On 25 September 2023, post public consultation, the CBDT notified final valuation rules amending Rule 11UA for computing FMV of unquoted equity shares and CCPS.

New valuation rules (amended Rule 11UA):

- ▶ **Effective date:** The amended Rule 11UA shall be effective from the date of publication in Official Gazette i.e., 25 September 2023.
- ▶ **Types of shares covered:**
 - ▶ The amended Rule 11UA prescribes valuation methods for unquoted equity shares and CCPS issued to resident and NR investors.
 - ▶ The change in valuation methods for CCPS is a variation as compared to the draft valuation rule issued earlier. The amended Rule 11UA also provides an option that FMV of CCPS can also be based on FMV of unquoted equity shares which is determined as per prescribed valuation methods
- ▶ **Valuation method for unquoted equity shares and CCPS:** The CHC has an option to select from any of the following valuation methods in relation to unquoted equity share or CCPS investment by residents and NRs:

Name of valuation method	Methodology	Applicable to which investor?	Applicable to type of share?	Change as compared to erstwhile Rule 11UA ⁹
Net asset value	Determined on normative basis using book value of assets and liabilities	Both resident and NR	Unquoted equity shares	No change
DCF	Determined by merchant banker	Both resident and NR	Unquoted equity shares and CCPS	Erstwhile Rule 11UA required valuation of CCPS as per Open Market Value
Five new valuation methods as per merchant banker report	<ul style="list-style-type: none"> • Comparable company multiple method • Probability weighted expected return method • Option pricing method • Milestone analysis method • Replacement cost methods 	Only NR	Unquoted equity shares and CCPS	New valuation method introduced for NR investors

- ▶ The valuation of preference shares other than CCPS continues to be based on Open Market Value based on report from a merchant banker or an accountant.

⁸ Refer EY Tax Alert titled "CBDT issues draft valuation rules for angel tax provisions for public consultation" dated 29 May 2023

⁹ In addition to consequential change of extension to investment by NR

► **Price matching facility for both resident and NR investment:**

- The price at which unquoted equity shares and CCPS are issued by CHC to NR entities notified in Notification No. 29/2023 shall be adopted as the FMV for the purposes of benchmarking 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 before or after¹⁰ the date of issue of shares which are the subject matter of valuation¹¹.
- 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. This is explained with the help of illustration in the amended Rule 11UA.

► **90 days window period for merchant banker valuation**

- Erstwhile Rule 11UA required merchant banker valuation report as on the date of issue of shares.
- The amended Rule 11UA provides flexibility by making the valuation report issued up to 90 days prior to the date of issue of equity shares and CCPS acceptable for computing FMV for investments by both resident and NR investors.
- Consequently, the reference to date of valuation stands modified from date of receipt of consideration to date of merchant banker valuation report.

► **Safe harbor valuation tolerance limit of 10%**

- Erstwhile angel tax provision and Rule 11UA did not provide for any safe harbor valuation tolerance limit.

- The amended Rule 11UA provides a tolerance limit of 10% for both resident and NR investors as follows:
 - In case of resident investor, if the issue price for unquoted equity shares is within 10% of price determined as per NAV or DCF method or if the issue price for CCPS is within 10% of price determined as per DCF method, then such issue price shall be deemed to be FMV of such shares.
 - 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 or if the issue price for CCPS is within 10% of price determined as per DCF or any of the five new methods, then such issue price shall be deemed to be FMV of such shares.
 - For this purpose, "issue price" is defined to mean the consideration received by the CHC for one share.

¹⁰ In the draft Rule, there was ambiguity on computation of window period of 90 days whether before or after receipt of consideration by CHC from notified NR entity. This aspect is clarified in the final Rule by including 90-day period both before and after receipt of consideration by CHC from notified NR entity

¹¹ The text of the rule suggests that the window of 90 days is qua date of issue of shares which are being valued. However, illustration in the amended rule, explains that window of 90 days is qua receipt of consideration from venture capital company/VCF.

Comments

The amendment in Rule 11UA was necessitated by extension of "angel tax" to investment in CHC by NR investors by Finance Act 2023. The amendments are intended to reduce valuation disputes by permitting more flexible modes of valuation.

As compared to draft valuation rules published on 26 May 2023, post stakeholder consultation, the finally notified amended Rule 11UA incorporates the following significant changes:

- Bringing parity between valuation of unquoted equity shares and CCPS (except for NAV method which applies only to unquoted equity shares)
- Clarifying the ambiguity on window period of 90 days for price matching facility

However, there is no change in the safe harbor tolerance limit of 10% which is intended to factor in the variations due to forex fluctuations, bidding processes, other economic indicators, etc. which may affect the valuation of the shares during multiple rounds of investment.

The safe harbor of 10% is applicable only in case of NAV, DCF and five new valuation methods. It is not extended to situations covered under price matching facility for shares issued to VCF/ specified funds or notified entities.

It is not clear why five new methods of valuation are proposed to be restricted to investments by NR investors only. This may create practical challenge and discrimination for resident investors even if issue price is same for both investors.

In relation to the price matching facility, the consideration received from other investors at such FMV should not exceed aggregate consideration received from notified/excluded NR entity. This restricts ability of the CHC to raise more funding from other resident and NR investors even though it is at same issue price.

The amended valuation rules are made applicable prospectively from 25 September 2023. A debatable issue may arise whether the amended valuation rule can be applied even for issue of shares from 1 April 2023 to 24 September 2023.

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