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EY Tax Alert

CBDT notifies specified class of investors and start-up companies exempt from angel tax provisions

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Executive summary

This Tax Alert explains a recent Notification Nos. 29 and 30 of 2023 dated 24 May 2023 (Notifications) issued by the Central Board of Direct Taxes (CBDT)[1] notifying the various classes of persons whose investments shall be excluded from the scope of angel tax provisions under the Income-tax Laws (ITL).

Notification No. 29/2023 enlists three categories of persons whose investments in closely held companies (CHCs) shall not be covered under the ambit of angel tax provisions viz. (a) Government and Government related investors (b) banks or regulated entities involved in insurance business and (c) Securities and Exchange Board of India (SEBI) registered Category-I foreign portfolio investors, endowment funds, pension funds and Broad-Based Pooled Investment Vehicles or funds with more than 50 investors (not being a hedge fund or fund which employs diverse or complex trading strategies) being resident in any country or specified territory from a list of 21 jurisdictions and regulated in the country where it is established, incorporated or resident. This Notification is effective from 24 May 2023.

Notification No. 30/2023 exempts start-up companies from the angel tax provision if the start-up company fulfils the conditions specified by Department for Promotion of Industries and Internal Trade 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 issues shares for a consideration at a premium to ***any person*** (whether resident or non-resident). The said Notification comes into force retroactively from 1 April 2023. It supersedes the earlier CBDT Notification No. 13/2019 which granted similar exemption to start-ups for issue of shares to ***resident*** investors.

[1] Apex body of direct tax administration in India

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Background

- Section 56(2)(viib) of the ITL (popularly known as the "angel tax" provisions) 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 fair market value (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 Rules[2] 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 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.

- The angel tax provisions empower the Central Government to notify certain class or classes of investors investing in CHC which are exempt from the rigors of angel tax. Pursuant to exercise of this power, in the past, CBDT had issued Notification No. 1131(E) dated 5 March 2019 notifying exemption to start-up companies registered with Department for Promotion of Industry and Internal Trade (DPIIT) which fulfil conditions specified in para 4 of Notification No. G.S.R 127(E) dated 19 February 2019 and file self-declaration to that effect, in respect of shares issued at premium to resident investors.

- 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 non-resident (NR) investor. FA 2023 also extended the exemption from angel tax to investments in CHC by venture capital funds set up in IFSC[3] (specified funds).

- The expansion of angel tax provisions gave rise to concerns regarding trigger of angel tax in investments made by genuine and regulated NR investors in Indian companies (including start-ups registered with DPIIT).

- In order to address the concerns, post stakeholder consultation, CBDT issued a Press Release on 19 May 2023 (Press Release) announcing that CBDT shall, *inter alia*, issue notification that certain class of NR investors shall be excluded from the ambit of angel tax provisions. It also clarified that earlier Notification No. 1131(E) dated 5 March 2019 shall be amended to cover investment in start-ups by any person (not merely residents).

CBDT Notification No. 29/2023 (Notification 1): Exclusion of specified class of investors

- CBDT has notified the following classes of persons who shall be excluded from the ambit of angel tax provisions:

    - **Government category:**

        - Government and

        - Government related investors such as: central banks, sovereign wealth funds, international or multilateral organizations or agencies or

        - Entities controlled by the Government or

        - Entities where direct or indirect ownership of the Government is 75% or more

    - **Banking and insurance category:**

        - 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

    - **Entities from specified jurisdictions:**

        - Any of the following entities which is a resident of any country or specified territory listed at Annexure to the Notification 1 and such entity is subject to applicable regulations in the country where it is established or incorporated as a resident:

            - Entities registered with SEBI as Category-I foreign portfolio investors

[2] Income-tax Act, 1961 r.w. Income-tax Rules, 1962

[3] International Financial Services Centre

- 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 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

▪ The Annexure to the Notification 1 lists 21 countries viz. Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, the UK and the US.

- The effective date is not mentioned in the Notification. As a general principle, a notification is effective from the date of its publication in Official Gazette. Hence, this Notification may be considered as effective from 24 May 2023 onwards.

CBDT Notification 30/2023 (Notification 2): Relaxation to start-up companies

- Earlier, CBDT Notification No. 13 of 2019 dated 5 March 2019 granted exemption to start-ups from angel tax provision if the start-up company complies with the conditions specified by the DPIIT at para 4 of DPIIT Notification No. S.O. 1131 (E) dated 5 March 2019. In order to claim exemption, the start-up company which fulfils the modified conditions[4] has to file a self-declaration stating that the eligible start-up has not invested in non-qualifying assets[5]. The self-declaration shall be transmitted by the DPIIT to the CBDT.

- Since the angel tax provisions were earlier applicable to shares issued to residents, the CBDT Notification No. 13/2019 granted exemption where start-ups issued shares to resident investors at a premium.

- As a consequential modification pursuant to expansion of scope of angel tax to NR investors, CBDT has issued Notification No. 30/2023 dated 24 May 2023 to grant exemption to start-up companies on shares issued to any person (which includes both resident and NR investors) on same conditions as was applicable earlier in respect of resident investors.

- The Notification No. 30/2023 comes into force retroactively from 1 April 2023. Thus, it covers any investment made by NR investor in DPIIT registered start-up company from 1 April 2023 till 23 May 2023 which fulfils the requisite conditions.

Comments

The relaxation granted by CBDT to various classes of investors and start-up companies is a welcome move. Such relaxation might provide impetus to investment by NR investors in CHCs (including start-up companies) by removing the tax hurdle of angel tax.

Further, Notification No. 29/2023 exempts specified investors from well-regulated 21 jurisdictions like Australia, Germany, the UK, the USA, Canada, etc. But India also receives significant foreign direct investment from other well-regulated jurisdictions like Singapore, Mauritius, Netherland, Luxemburg, etc. It is not clear why such jurisdictions are kept out.

The Press Release specified the intent of the CBDT to exclude certain NR investors from the scope of angel tax provisions. However, the Notification No. 29/2023 does not specifically refer that the classes of investors which are notified should be NR investors. Hence, as one possible reading, even investments by Indian banks and insurance companies in CHCs may be protected from angel tax.

The Notification No. 29/2023 does not provide the definition of any terms like Government, banks, hedge funds, etc. Hence, one will have to rely on allied laws to understand the scope of the terms.

CBDT is yet to issue a draft of amended valuation rule for computing FMV which as per the Press Release will be available for public comments for 10 days.

[4] Start-up with an aggregate share capital and share premium consequent to past or proposed issue of shares of INR250m excluding shares issued to NRs, venture capital company (VCC) or a venture capital fund (VCF) or a specified listed company.

[5] In order to restrict the exemption to bonafide cases, the DPIIT has imposed restriction on start-ups for investing in certain non-qualifying asset within seven years of the latest issue of shares.

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