

EY Flash News

CBDT proposes relief from angel tax pursuant to Budget 2023 amendment expanding scope to non-resident investment

Background

- ▶ Section 56(2)(viib) of the Income Tax Act (popularly known as the "angel tax" provision) is an anti-abuse provision which applies when a Closely Held Company (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. However, investments by venture capital funds (VCFs) are exempted from angel tax.
- ▶ Rule 11UA of the Income Tax Rules¹ 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.

¹ Income-tax Act, 1961 r.w. Income-tax Rules, 1962

- ▶ 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 non-resident (NR) investors. FA 2023 also extended the exemption from angel tax to investments in CHC by VCFs set up in IFSC² (specified funds).
- ▶ Stakeholders made various representations to the Government on challenges arising from expansion of angel tax to investments by NR investors.

Press release dated 19 May 2023:

- ▶ Pursuant to interactions with stakeholders, the Central Board of Direct Taxes (CBDT)³ has issued a press release on 19 May 2023 announcing a slew of relief on aspects of angel tax. While some are applicable exclusively to investment by NRs, some are applicable to investment by both residents and NRs. The press release explains the proposed changes which will be carried out through amendment to Rule 11UA and issue of notifications.

▶ **Five new valuation methods for NR investment:**

- The existing Rule 11UA prescribes two methods (viz. NAV or DCF) for determining FMV of shares issued to investors. CBDT proposes to include five more valuation methods for NR investors.
- **Price matching facility for both resident and NR investment:**
 - Also, the price at which equity shares are issued by CHC to the notified NR entity shall be adopted as FMV for the purposes of benchmarking equity investments by both resident and NR investors, subject to compliance of the following conditions:
 - The consideration received from other investors at such FMV does not exceed the 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 and specified funds.

- **90-day window period for merchant banker valuation**
 - Existing Rule 11UA requires merchant banker DCF valuation report as on the date of issue of shares.
 - As per the press release, valuation report by the merchant banker of a date not more than 90 days prior to the date of issue of shares shall be accepted. While it is not expressly mentioned, it appears to apply to investment by both residents and NRs.

Safe harbor valuation tolerance limit of 10%

- Existing angel tax provision and Rule 11UA does not provide for any safe harbor valuation tolerance limit.
- As per the press release, a tolerance limit of 10% shall be introduced to factor in variations due to forex fluctuations, bidding processes and other economic indicators, etc. which may affect the valuation of the unquoted equity shares during multiple rounds of investment. While it is not expressly mentioned, it appears to apply to investment by both residents and NRs.

▶ **Draft amended Rule 11UA to be published for public comments** - CBDT shall publish the draft amended Rule 11UA incorporating the above referred changes for public comments for a short period of 10 days, after which they will be notified.

▶ **Proposal to exclude certain NR investors from angel tax provision:**

- CBDT shall notify following classes of NR investors who shall be excluded from the ambit of angel tax provisions:
 - Government and Government related investors such as central banks, sovereign wealth funds, 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.
 - Banks or regulated entities involved in insurance business.

² International Financial Services Centre

³ The apex administrative body for direct taxes

- Any of the following entities, which is a resident of certain countries or specified territories having robust regulatory framework:
 - Entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors (Category 1 FPI).
 - 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 a 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.

► **Relief to DPIIT recognized start-ups:** CBDT shall amend its earlier notification dated 5 March 2019 to extend non-applicability of angel tax provisions to consideration received by start-up recognized by DPIIT⁴ and fulfilling certain conditions from any person (i.e., not restricted to residents).

A detailed alert shall be released on publishing of draft amended Rule 11UA for public comments.

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