Taxation of Angel Investments

What is the issue?

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The angel tax provisions for domestic start-ups are seriously flawed and need to be done away with.

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What was the proposed measure?

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- An angel investor is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.
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- However, there were instances of individuals using unlisted companies to receive angel investments as black money and converting them into white.
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- Thus, a taxation on angel investments had been introduced in the 2012 budget as an anti-money laundering provision.
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- The provision states that angel tax will be applicable, when any closely-held company issues shares to domestic investors at a price higher than its fair market value.
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- A closely held corporation is any company that has only a limited number of shareholders.
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- This excess amount is to be considered as “income from other sources” and should be taxed at 30% under Section 56 (II) of the Income Tax Act.
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- **Calculating Fair market value** – It is to be determined only through book value or discounted cash flow methods, failing which an assessing officer will intervene for assessment.
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- A company's book value is its total assets minus intangible assets and liabilities.
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- Discounted cash flow (DCF) is a valuation method used to estimate the value of an investment based on its future cash flows.
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What are the concerns?

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- Accounting income arises only when the business uses this capital to create a product which yields a profit.
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- Thus, treating the entire equity capital received by a business as taxable income is plainly wrong.
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- The valuation of a business is an issue best left to a venture and its investors.
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- Expecting new-age start-ups to use “book value” methods and seek the intervention of an assessing officer every time they raise funds is draconian and opens the doors to misuse.
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- Also, taxing domestic investors will make home-grown start-ups to offshore their holding company and source capital through circuitous routes to subvert this rule.
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What was the response from the government?

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- The Central Board of Direct Tax (CBDT) has recently granted some relief from this tax for start-ups that comply with conditions notified by the DIPP.
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- These qualifying conditions have been stipulated for both the start-up and angel investors.
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1. For the start-up: Maximum cap of paid up share capital and share premium

of Rs.10 crores.
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2. <u>For angel investors</u>: Minimum average returned income of Rs.25 lakhs for the preceding three financial years (or) minimum net worth of Rs.2 crores as on the last date of the preceding financial year.
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- In order to avail the exemption, a start-up would first need recognition as an eligible start-up (approved by DIPP).
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- This should be followed by a specific application to the Inter-Ministerial Board of Certification (IMB) to issue shares without triggering the angel tax provisions.
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- Also, the application needs to be accompanied by a fair valuation certificate from a merchant banker.
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What are the challenges in availing exemptions?

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- **Capital** - The capital threshold of Rs.10 crores is likely to benefit only a small number of start-ups.
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- This will adversely impact those start-ups that are involved in capital intensive businesses.
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- **Small investments** - Many small investors look to undertake their investment plans in individual capacity without being a part of any angel network fund.
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- Thus, the minimum threshold criteria for angel investors can be deterring for these small investors.
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- Also, the requirement of valuation by a merchant banker also escalates the cost for start-ups and angel investors.
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- **Administrative hurdles** - Start-ups would have to go through the administrative hurdle and <u>multi-stage approval process</u> required for availing exemption from the angel tax (DIPP registration followed by IMB approval).

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- **Past investments** - The exemption notification eases the nerves of only future investors looking to invest in certified start-ups.
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- However, unregistered start-ups, who have already raised angel investment, may continue to find themselves in the crossfire with the income tax authorities.
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- This will result in pro-longed disputes and litigation with respect to their investments.
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What should be done?

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- India relies so heavily on its start-up ecosystem to innovate, create jobs and drive the next leg of economic growth.
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- Thus, a tax on angel investments existing itself is a cause of concern.
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- The Centre has promised that angel tax demands would not be raised on genuine start-ups and coercive measures would be avoided.
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- It has also appointed an expert committee to review these rules.
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Source: Business Standard, Livemint

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