

# **Taxation of Angel Investments - II**

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#### Why in news?

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The government has released a new notification easing norms for exemption from the angel tax under Section 56 of the Income-Tax Act.

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## Why was there a necessity for this notification?

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• Under Section 56(2) of the I-T Act, Angel Tax are taxes on any investments made by an Indian entity in an unlisted Indian company above fair market value as income.

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• The provision was introduced in 2012 with the intent of curbing the laundering of black money.

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 However, this levyplaces the power to evaluate a company in the hands of Income Tax inspectors, whose valuation and methods are at odds with the start-up ecosystem and investors.

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• This is because even the most experienced venture capitalists get valuations right very rarely.

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• This mismatch between how investors evaluate a start-up and how the Assessing Officer (AO) does so lies at the heart of the unrest and distress within the community.

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• Hundreds of start-ups that raised angel funding in AY2015-16 and 2016-17

have received notices from the Income Tax department.

- $\bullet$  The notices question the high share premium at which the shares have been allocated during the funding.  $\mbox{\sc harping}$
- This has impacted angel investors as their investments typically exceed what is regarded as fair value.

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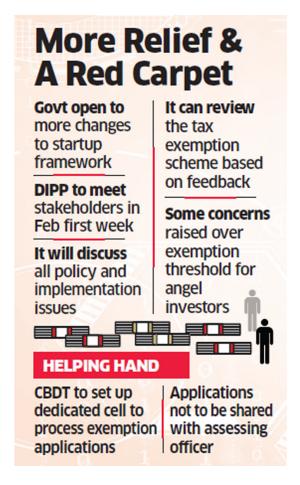
## What does the notification say?

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- On approval As per the notification, certification from an inter-ministerial body for seeking exemption from angel tax has been done away with.
- Now, a start-up can fill up a form with the requisite documents and submit it to the Department of Industrial Promotion and Policy (DIPP), which will forward it to the Central Board of Direct Taxes (CBDT).
- $\bullet$  The CBDT is mandated to evaluate and respond to each application within 45 days.
- $\bullet$  Besides, the CBDT will soon set up a dedicated unit for processing requests from startups and angel investors for exemption to expedite the process. \n

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• **For start-ups** - The aggregate amount of paid-up share capital and share premium of the start-up after the proposed issue of share does not exceed 10 crore rupees.

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• **For investors** - The investor shall have a returned income of Rs 50 lakh or more for the financial year preceding the year of investment and net worth exceeding Rs 2 crore.

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• The exemption provision will be applied with retrospective effect from April 2016.

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#### What are the concerns with the notification?

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• **Eligibility** - The angel investors, to be eligible for tax exemption, are required have a declared income of Rs 50 lakh or more and net worth exceeding Rs 2 crore.

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- For a lot of start-ups, the first investors are <u>friends and family members</u> and most of them would not be able to fulfil this criterion.
- Also, the provision requires the investors to share their source of funds with the start-up seeking an exemption.
- $\bullet$  Thus, instead of fulfilling both criteria of income and net worth, they should follow the global model of fulfilling any one criteria. \n
- Also, lowering the threshold to Rs 25 lakh of income or a net worth of Rs 1 crore could be considered.

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- **Exemption limit** The exemption limit of Rs 10 crore is arbitrary and it affects capital flow for a start-up.
- $\bullet$  This is because raising further rounds of funding are important accelerants to growth and business development for a start-up.  $\mbox{\sc h}$
- Also, it is not clear whether the exemption provisions apply to both a transfer as well as the issuance of fresh shares.
- **Discretion** Though some norms have been eased, the procedure to apply for exemption still remains cumbersome.
- The new procedure to seek exemption involves an application made by the start-up to the CBDT, via DIPP.
- Thus, the DIPP has the discretion in either clearing exemption or raising tax demands.

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- Assessment of fair value The angel tax is calculated with the help of "fair value" of a new business.
- $\bullet$  But fair value is impossible to ascertain for an unlisted new business. \n
- A new business has no track record and it may be light on assets as well, especially if it is in the services sector.
- Hence, it is impossible to judge, whether any given valuation is fair or not.

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• Thus, instead of the asset-based evaluation of companies, the <u>Discounted Cash Flow (DCF) method</u> should be followed, which takes into account future growth prospects.

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• This method would be much more accurate to assess fair value for asset-light technology start-ups.

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**Source: Business Standard, The Quint** 

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