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In the recently presented Union Budget 2023, it has been proposed to expand the applicability of Section 56(2)(viib) of the Income-Tax Act, 1961 (the Act), commonly referred to as Angel Tax Provisions, to the issue of shares by a closely-held company to non-resident investors. Thus, the provisions of Section 56(2)(viib) of the Act are intended to apply to the receipt of consideration from any person, irrespective of their residential status. Expectedly, there has been a lot of discussion on the impact that this change would have on the flow of Foreign Direct Investments in India, the start-up ecosystem, and the investment fraternity in general. In this article, we have delved into the various nuances of these provisions.

Section 56(2)(viib) was introduced to combat the generation and circulation of unaccounted money received by a closely-held company through share premium without being backed by appropriate valuations justifying the same. Where a closely-held company issues shares at a premium, the consideration exceeding fair market value is deemed as income in the hands of the company.

The mechanisms for computing the Fair Market Value (FMV) have been prescribed under Rule 11UA of the Income Tax Rules, 1962 (the Rules).

It is pertinent to note that the section covers all types of shares and is not limited to the issuance of equity shares. Thus, the issue of preference shares would also get covered under this provision irrespective of the fact as to whether the shares are convertible or not.

While this provision was introduced as an Anti-Tax Avoidance tool and applicable to all closely-held companies, it became widely known as 'Angel Tax Provisions' with the growth of start-ups in India. It was called Angel Tax as it impacted investment by Indian angel investors- HNIs and family offices who invested in start-ups. This tax was applicable on start-ups who raised funds from angel investors in cases where share issue prices exceeded the value determined as per the valuation method prescribed under the Rules. Hence, start-ups often found themselves in the middle of tax litigations with revenue authorities over disputes on share valuations. In other words, the Angel Tax proved to be a major deterrent to start-up investments.

In its attempt to rationalize the inflow of investments in start-ups, the government extended relief from Angel Tax Provisions to eligible start-ups on the satisfaction of certain conditions[1]. A start-up is eligible for exemption from Section 56(2)(viib) of the Act if it is recognized by the Department for Promotion of Industry and Internal Trade (DPIIT) and the aggregate paid-up capital and share premium after issue/proposed issue does not exceed INR 25 crores.

To be recognized by the DPITT, an entity must satisfy several conditions, one of which is to obtain a certificate of an eligible business from the Inter-Ministerial Board of Certification as constituted by the DPIIT from time to time. The eligibility conditions were severely restrictive in terms of the turnover (not exceeding INR 100 crores in any preceding year), and the nature of business of the start-ups (working towards innovation, development or improvement of products, processes, or services, or a scalable business model with a high potential of employment generation or wealth creation), among others.

As a result, start-ups that may not satisfy the above conditions continued to fall within the ambit of the Angel Tax provisions. Moreover, since the valuation of start-ups is based on future growth prospects, this basis is often rejected by tax authorities. As per a survey performed by the community-based social network Local Circles in 2019, 73% of the 2500 start-ups that participated in the survey said they had received income tax notices since inception. 70% of those notices were in relation to Section 56(2)(viib).

Various News reports, including the Economic Times, have covered issues in terms of tax notices and questions faced by start-ups on valuations. The main area of concern for start-up entrepreneurs and angel investors was the manner in which the fair valuation of the start-up was assessed by income tax officials. It was reported that in most cases, the valuations were worked out by the officers at their discretion in a completely arbitrary manner.

This leads us to the question as to whether **valuations can be called into question by tax authorities?**

The Act prescribes that the valuation of shares for Section 56(2)(viib) shall be the value:

a. As may be determined in accordance with Rule 11UA of the Rules (which provides an option of either the Net Asset Value (NAV) method or Discounted Cash Flow (DCF) valuation (by category/merchant bankers) or As may be substantiated by the company to the satisfaction of the tax authorities based on the value of its asset, including intangible assets, **whichever is higher.**

Earlier, various judicial forums have acknowledged and upheld the professional competency and expertise of valuers in undertaking the valuation exercise[2]. However, in the recent past, the approach adopted by the Courts and Tribunals suggests that the tax authorities may not accept the valuation reports at face value, and they would have to be justified by the taxpayers.

1. The conditions were laid down in DPIIT notification G.S.R 127(E) dated 19 February 2019
2. T.D. Venkata Rao v Union of India [1999] 237 ITR 315 (SC), Sarma (A.S.) v. Union of India [1989] 175 ITR 254 (AP)
   Nataraj (T.S.) v. Union of India [1985] 155 ITR 81(Kar.) Rajkot Engineering Association v. Union of India [1986] 162 ITR 28(Guj.), Miheer H. Mafatlal vs Mafatlal Industries Ltd [JT 1996 (8) 205]

The said issue came up for the first time before the Kolkata Bench of the Tribunal in the case of Microfirm Capital (P) Ltd[3]. In this case, the Tribunal rejected the contention that if an Assessing Officer (AO) is not satisfied with the value determined by the expert valuer, then the only option is to get it done by another expert valuer. The Tribunal held that the AO not only has a right but is also duty-bound to examine the valuation report and record their findings. Such findings should be based on relevant material and the rational view taken in a judicious manner. Thus, this decision gave powers to the AO to examine the valuation report submitted by the taxpayer.

This was followed by the Delhi Tribunal judgment[4] wherein it was held that fair valuation by a merchant banker could only be verified if the taxpayer provided **sufficient evidence to substantiate the basis of cash flow projections and to establish reasonable connectivity between projections and reality.** It also emerged that a valuer cannot solely rely on information provided by management. Valuers are required to independently verify the data. Due diligence on the part of the valuer in verifying the truthfulness, accuracy, and completeness of the information provided is a pre-requisite. **In the absence of sufficient evidence to substantiate projections for the DCF valuation, the officer is justified in rejecting the DCF valuation and adopting the NAV method.**

Although the tide seemed to be against taxpayers, a slight relief came in the form of the below rulings that tried to draw boundaries on the powers of revenue authorities with respect to valuation:

- In one of the rulings before the Bangalore ITAT in the case of Town Essential Pvt Ltd[5], the taxpayer had adopted the DCF method for valuing fresh issue of shares. However, the taxpayer failed to prove the correctness of the projections used in this regard to the satisfaction of the AO. Accordingly, the AO adopted the NAV method to determine the share value. The Bangalore Tribunal noted that, while the AO may determine fresh valuation if not satisfied with the value adopted by the taxpayer, the basis of the same must be DCF and cannot be another method. Furthermore, the basis of valuation can only be the facts and data available on the date of valuation rather than the actual results of the future.

- Another ruling in this context was rendered by the Ahmedabad Tribunal in the case of Gaurav Hotels (P) Ltd[1][6]. In the said case, the taxpayer had used an NAV-based valuation by adopting the market value for land and building. The said valuation was backed by a Chartered Accountant's report justifying the same. The AO rejected such a valuation holding that the book value approach needs to be considered. However, the Tribunal rejected the AO's contention. It ruled that where the taxpayer has clearly adopted the second method prescribed in Section 56 (asset-based value) and the AO finds no infirmity in the supporting valuation reports, such share valuation is justified.

3. Microfirm capital (P) Ltd v. DCIT [2018] 89 taxmann.com 23 (Kolkata-Trib)
4. Agro Portfolio (P) Ltd. v. ITO [2018] 94 taxmann.com 112 (Delhi - Trib)
5. Town Essential (P) Ltd v. CIT(A) [2021] 130 taxmann.com 263 (Bangalore Tribunal)
6. Gaurav Hotels (P) Ltd v. ITO [2022] 137 taxmann.com 409 (Ahmedabad Tribunal)

- While the start-ups are already on their toes with respect to valuations, fresh challenges await them in the wake of the recent Budget amendments. With the government proposing to expand angel taxation to the issue of shares to non-residents in the recent budget, greater scrutiny is expected for start-ups that are funded by overseas investors.

What the recent budget implies for investments into India?

Finance Bill 2023 proposes to expand Angel Tax Provisions to the issue of shares by a closely-held company to non-resident investors. Thus, the provisions of Section 56(2)(viib) of the Act are intended to apply to the receipt of consideration from any person, irrespective of their residential status.

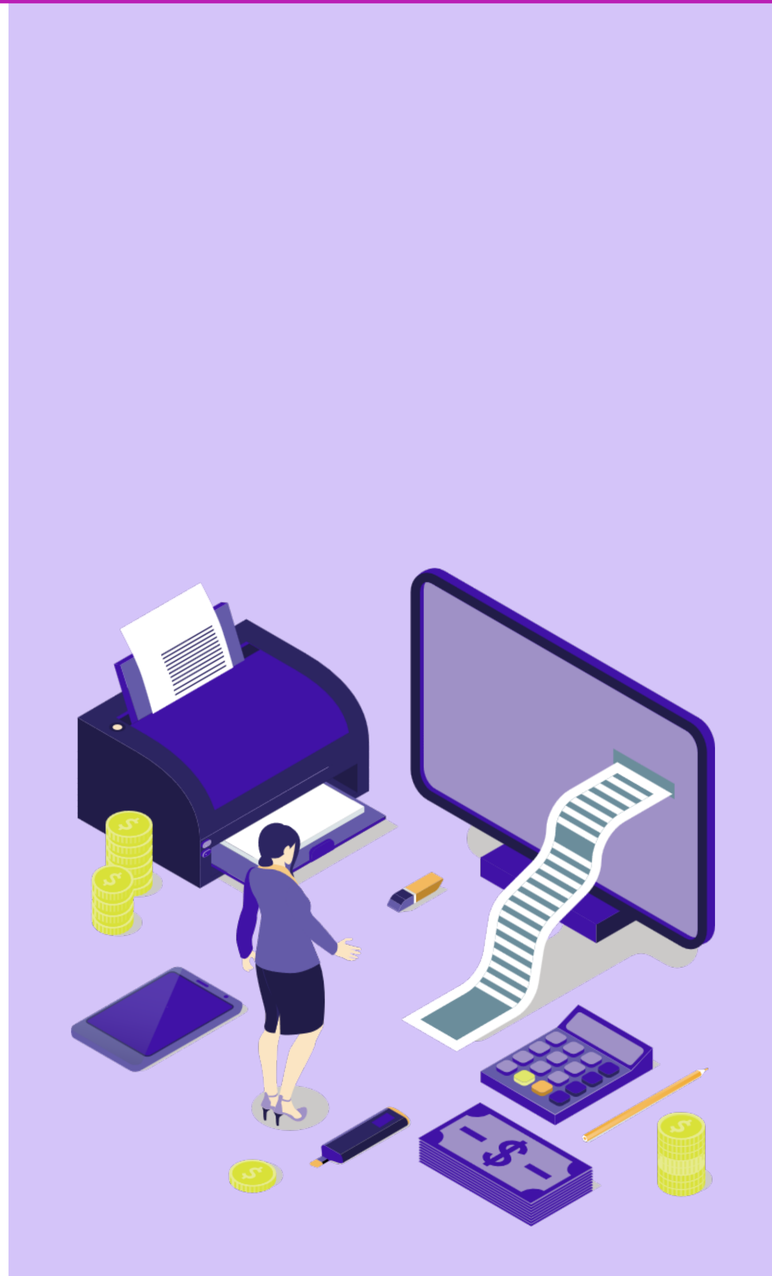
While the rationale for the amendment does not explicitly come out from the memorandum to the budget, the heading to the clause mentions it to eliminate the possibility of tax avoidance. Thus, now the issue of shares will have to be at a consideration that does not exceed its fair market value. Any excess of the consideration over the FMV shall be taxable as income in the hands of the company. Since the valuation aspect in the case of issuance of shares to a non-resident is governed only by the provisions of the Companies Act and the Foreign Exchange Management Act (FEMA), bringing it within the purview of even income tax valuation requirements will certainly have far-reaching effects.

Under the erstwhile FEMA regulations relating to overseas investment, reinvestment of funds to India was permissible with specific prior approval from the Reserve Bank of India (RBI). Thus, cases involving round-tripping were handled on a case-to-case basis with much scrutiny. However, under the amended framework, the RBI has permitted round-tripping for genuine business reasons, subject to restrictions on the number of layers. Thus, such cases may not require undergoing the rigors of obtaining RBI approval.

While the requirement of having a genuine business reason has been retained, there may be a practical challenge in identifying cases involving tax avoidances/leakages and tracing the source of funds. This could be one of the possible reasons to have an anti-abuse provision as a safeguard under the tax legislation.

However, this amendment may pose a challenge in meeting the valuation requirement. It is pertinent to note that as per the provisions of FEMA, the issue of shares has to be at least at FMV. Thus, issue of shares at a consideration below the FMV is not permissible as per FEMA. On the contrary, the income tax provisions would require the issue of shares to be at a consideration at or below the FMV. Generally, the methodologies under both laws would be the same (internationally accepted methodology of valuation basis discounted free cash flows). This results in a dichotomy and the only way out would be to issue the shares at exactly the FMV. On the other hand, the extension of Angel Tax to non-residents may also negatively impact FDI into India and the start-up ecosystem which primarily relies on investors' money to funnel growth.

Thus, it would be interesting to see how these issues get addressed before the passage of the Bill to become an Act.



Conclusion

Given the current market scenario, successful fundraising is the key not only for start-ups but also for all companies in general to realize their expansion plans. However, the Angel Tax Provisions, along with other market-driven factors, serve as an impediment for investments in start-ups. The restrictive nature of eligibility conditions for availing tax exemptions add to the woes of start-ups. Furthermore, the uncertainty with respect to valuations also creates hassles at the tax assessment stage.
In this context, the new amendment extending the Angel Tax Provisions to the issue of shares to non-residents is not a welcome move. We must keenly watch the developments on any reliefs that may be extended from the new Angel Tax Provisions over the coming months.

About Nexdigm

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Our multidisciplinary teams serve a wide range of industries, with a specific focus on healthcare, food processing, and banking and financial services. Over the last decade, we have built and leveraged capabilities across key global markets to provide transnational support to numerous clients.

From inception, our founders have propagated a culture that values professional standards and personalized service. An emphasis on collaboration and ethical conduct drives us to serve our clients with integrity while delivering high quality, innovative results. We act as partners to our clients, and take a proactive stance in understanding their needs and constraints, to provide integrated solutions. Quality at Nexdigm is of utmost importance, and we are ISO/ISE 27001 certified for information security and ISO 9001 certified for quality management.

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