Budget 2023: Angel tax on share consideration received from non-resident investors

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In a proposed amendment likely to complicate the process of fund-raising from foreign investors and conversion of convertible instruments, the Finance Bill, 2023 proposes to cover non-resident investors within the ambit of Section 56(2)(viib) (commonly referred to as the 'angel tax' provision) of the (Indian) Income Tax Act, 1961.

1 Background

The angel tax provision was originally introduced by the Finance Act, 2012, ostensibly to deter the generation and use of unaccounted money. Under the provision, the excess of the consideration received by a privately-held company (**PLC**) for the issue of shares, over the fair market value (**FMV**) of the shares, is deemed to be the income of the PLC. Such income is taxed at the corporate tax rate applicable to the PLC.

The angel tax provision does not apply where the consideration for the issue of shares is received by a venture capital undertaking from a venture capital fund or a specified fund (broadly a Category I or a Category II Alternative Investment Fund), or by notified start-ups that meet certain conditions and have been recognised in the prescribed manner. More importantly, in its current form, the provision only applies to excess consideration received by a PLC on the issue of shares to *resident* investors.

2 Proposal under the Finance Bill, 2023

The Finance Bill, 2023 (**Bill**) proposes to apply the angel tax provision to excess consideration received by a PLC on the issue of shares to *non-resident* shareholders as well. The amendment will apply with effect from financial year 2023-24. Given that the provision in its current form contains limited exceptions (with the exemption accorded to notified start-ups being subject to restrictive conditions), the proposal, if enacted, may adversely impact PLCs seeking to raise capital at a premium from non-resident investors.

3 Impact on the issuance of shares

Interestingly, the (Indian) Income Tax Act, 1961 (**ITA**) also contains a deemed income provision in Section 56(2)(x) (**deemed income provision**), in terms of which if the acquirer of certain kinds of property (including securities) receives such property for a consideration lower than the FMV computed in the prescribed manner, the excess of the FMV over the consideration is taxed in the hands of the acquirer. The position of the tax authorities is that the deemed income provision applies to shares acquired through a primary issuance as well.

If the proposed amendment to the angel tax provision is enacted, from a tax perspective, it would be important for the share issue price to comply with both these provisions. Otherwise, there may be adverse tax implications for either the PLC issuing the shares, or the investors subscribing to such shares. While this is already the case for shares issued to resident investors, going forward, similar considerations would apply to capital raised from non-resident investors.

This in itself may not be a significant concern, given that the valuation rules prescribed under both provisions are different, and leave some leeway for a tax-compliant share issuance that does not result in adverse consequences for the PLC or the investors. To elaborate, under the angel tax provision, the FMV of equity shares may be computed by employing a Net Asset Value (**NAV**) based method or the Discounted Cash Flow (**DCF**) method at the option of the taxpayer (i.e., the PLC issuing the shares). On the other hand, under the deemed income provision, the FMV of equity shares must be computed by employing a NAV based method only. For a going concern issuing shares, the DCF value usually exceeds the NAV based value. Given this, PLCs issuing equity shares usually opt for the DCF method for the purposes of the angel tax provision. In such a scenario, equity shares issued at a value above the NAV and below the DCF value meet the requirements of both provisions, and do not result in any adverse tax implications for the PLC issuing the shares or the investors.

If the proposed amendment is enacted, from a tax law perspective, similar considerations would apply to shares issued to non-resident investors as well. However, unlike shares issued to resident investors, shares issued to non-resident investors must also comply with the valuation requirements under foreign exchange management (**FEMA**) laws. The proposed amendment, if enacted, may conflict with the valuation norms under the FEMA regulations, and impact the ability of PLCs to raise capital from non-resident investors.

Under FEMA regulations, shares must be issued to non-residents on *at least* FMV basis. Therefore, while the angel tax provision prescribes a ceiling value (beyond which there would be adverse tax implications for the issuing PLC), FEMA regulations prescribe a floor price. To this extent, the angel tax provision and FEMA pricing requirements appear to be at odds with each other. In such a scenario, to ensure that there are no consequences under the angel tax provision or FEMA regulations, the PLC will seemingly need to issue shares at exactly the FMV, which is highly restrictive and may not be commercially feasible.

There is, however, a bit of nuance that needs to be considered at this stage. Unlike tax rules, FEMA regulations do not prescribe a specific valuation method. Instead, valuation may be conducted by employing *any internationally accepted* methodology. While this *generally* implies the DCF method, this may not always be the case, depending on the business and operational model of the PLC issuing the shares. If the FMV under FEMA regulations (**FEMA FMV**) is computed by employing a method other than the DCF method, it is likely to differ from the FMV computed for the purposes of the angel tax provision (**tax FMV**), which would generally be computed by employing the DCF method, as discussed above. In such a situation, if the FEMA FMV is lower than the tax FMV, there should not be an issue – the equity shares may be issued at a value ranging between the FEMA FMV and the tax FMV, without running afoul of tax or FEMA regulations. On the other hand, if the FEMA FMV exceeds the tax FMV, it may not be possible for the PLC to issue equity shares without incurring a tax cost, given that the FEMA FMV would be the floor price for the issuance, which would exceed the tax FMV under the angel tax provision.

4 Impact on the conversion of convertible instruments

If the proposed amendment is enacted, then apart from the considerations discussed above in the context of share issuances, there may also be complexities in the conversion of convertible instruments (such as preference shares or debentures) into equity shares. In the past year, the Income Tax Appellate Tribunal (**ITAT**) has delivered conflicting rulings on the applicability of the angel tax provision in case of conversion of preference shares/debentures into equity shares.

In one ruling, the taxpayer PLC had issued compulsorily convertible debentures (**CCDs**) to several investors in an earlier financial year. During the subject year, these CCDs were converted into equity shares at a premium. The assessing officer invoked the angel tax provision and taxed the premium in the hands of the taxpayer PLC. The taxpayer contended that the angel tax provision seeks to tax any excess consideration *received* by a closely held company on the issuance of its shares. However, in the facts of the case, no consideration was received at all at the time of conversion. The entire consideration was received at the time of issuance of the CCDs, i.e., in an earlier year. Since the conversion of the CCDs into equity shares during the subject year did not involve any inflow of money, the angel tax provision would not apply.

However, the ITAT rejected this argument and observed that the angel tax provision employs the term '*consideration*' and not the terms '*amount*' or '*money*'. Therefore, the provision encompasses consideration in all forms and is not limited to receipt of money/cash consideration. The ITAT observed that on the conversion of CCDs into equity shares, the issuer-company may receive consideration in several forms, including the extinguishment of the debt obligation, release of the charge on its assets, an improved debt-equity ratio, etc. Therefore, the ITAT held that the angel tax provision would apply to conversion transactions as well, provided the conditions stipulated in the provision are fulfilled.

On the other hand, in another ruling involving the applicability of the angel tax provision to the conversion of optionally fully convertible debentures (**OFCD**) into non-cumulative preference shares, the ITAT held that the use of the word "*receives*" in the provision is indicative of the fact that for the provision to apply, shares must be issued and consideration must be received in the same year. Since no consideration was received in the year of conversion of the OFCDs, the angel tax provision was inapplicable.

Such disputes are expected to become more prevalent if the proposed amendment is enacted and proceeds received from non-resident investors are brought within the ambit of the provision. Further, if the applicability of the angel tax provision to conversion transactions is upheld in principle, there may also be valuation related conflicts between the angel tax provision and FEMA regulations. For instance, under FEMA regulations, convertible instruments cannot be converted at a price lower than the initial subscription price of such instruments paid by the non-resident investor. This is the case even when there has been a drop in the valuation of the company. In such a scenario, if the angel tax provision is applied at the time of the conversion of the securities, the tax FMV of the shares of the PLC at the time of conversion may be lower than the price at which the convertible instruments were issued.

Given that under FEMA regulations, the conversion cannot be undertaken at a price below the original issue price, the conversion of the instruments into equity shares may result in a tax cost for the PLC under the angel tax provision (since the conversion price would exceed the tax FMV). There may be similar implications if there is a pre-agreed conversion price that is higher than the tax FMV computed at the time of the conversion.

5 Conclusion

To summarise, going forward, non-resident investors and PLCs may need to carefully assess the interplay of tax laws and FEMA regulations for conversion and share issuance transactions. Further, the comfort of the Reserve Bank of India and the authorised dealer banks with valuation methods other than the DCF method may also need to be gauged. It would be even more important for investors as well as PLCs to procure robust valuation reports based on justifiable assumptions and projections, both from the perspective of tax and FEMA regulations.

Given the complexities and considerations highlighted above, it is hoped that the proposed amendment is reconsidered. If enacted, the provision is likely to impact foreign direct investment in India, which is clearly not a desirable outcome at the present juncture. There are reports that the income tax department intends to come out with modified valuation rules under the ITA to resolve the dichotomy between the valuation under the tax law and FEMA provisions. The import and impact of the modified tax valuation rules will need to be assessed when the amendment is introduced.
