UPDATES

New valuation rules under the Angel Tax regime

17 October 2023

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This update covers:

1 Background

Following a public consultation, new valuation rules for the issue of equity and preference shares to residents and non-residents have been finalised and made applicable from 25 September 2023. This update analyses the key provisions of these rules and highlights a few legal lacunae that remain unaddressed.

The Central Board of Direct Taxes (**CBDT**) had earlier issued a draft notification on 26 May 2023 seeking public comments on new valuation methods proposed to be prescribed for the issue of equity shares to residents and non-residents. (To read our detailed update on the draft notification, click here.)

After receiving public comments, the CBDT has now issued the Income Tax (Twenty-First Amendment) Rules, 2023 (**Rules**), finalising the new valuation rules, applicable from 25 September 2023, for the issue of equity shares as well as preference shares to residents and non-residents. These Rules amend Rule 11 UA of the Income Tax Rules, 1962.

The excess of the consideration received by a private limited company (**PLC**) for the issue of shares to residents and non-residents, over the fair market value (**Tax FMV**) of the shares as prescribed in these Rules, is deemed to be the income of the PLC as per the provisions of the Income Tax Act, 1961 (**ITA**). Such income is taxed at the corporate tax rate applicable to the PLC (**Angel Tax**). On the positive side, the Rules offer multiple valuation methods to determine the Tax FMV, however, the Rules do not address many issues especially those related to convertible instruments, as discussed below.

2 Key highlights of the Rules

2.1 Methods applicable

The Rules provide various methods for the valuation of equity shares as well as preference shares as follows.

Method	Particulars
A	Net Asset Value (**NAV**) based method
B	Discounted Cash Flow (**DCF**) method based on a report by a merchant banker
C	Price of shares issued by a venture capital undertaking to a specified fund may be considered as the Tax FMV for the issue of shares to another investor within a period of 90 days.
D	Any of the five methods mentioned below based on a report by a merchant banker: ▪ Comparable Company Multiple Method ▪ Probability Weighted Expected Return Method ▪ Option Pricing Method ▪ Milestone Analysis Method ▪ Replacement Cost Method
E	Price of shares issued by a PLC to a notified investor may be considered as the Tax FMV for issue of shares to another investor within a period of 90 days.

The applicability of the methods mentioned above will depend on the type of investor and type of share issued, as below:

Issue of equity shares to a non-resident	Issue of equity shares to a resident	Issue of preference shares to a non-resident	Issue of preference shares to a resident
All methods	All methods except D	Methods B, C, D, E or based on the FMV of equity shares determined in accordance with any of the above methods.	Methods B, C, E or based on the FMV of equity shares determined in accordance with any of the above methods except D.

2.2 Safe harbour

For shares issued to investors, the issue price will be accepted as the Tax FMV for the Angel Tax provision, so long as it does not exceed the value computed using the prescribed valuation methods by more than 10%.

2.3 Valuation date

Where the valuation report issued by the merchant banker is dated not more than 90 days prior to the date of issue of shares, the company may choose to deem the date of the valuation report as the valuation date. The valuation date here refers to the date of the report and not to the '*valuation date*'.

3 Analysis of the amendments to Rule 11UA

a. ***Rules are now restrictive for issue of preference shares:*** Until 25 September 2023, PLCs were allowed to use any method as deemed fit by the merchant banker for valuing preference shares. The merchant banker will now be required to use only the specified methods.

b. ***Conversion of convertible instruments not addressed:*** Under the Foreign Exchange Management Act, 1999 (**FEMA**), convertible instruments cannot be converted at a price lower than the fair value of such instruments at the time of issuance of such instruments. In a scenario where there is a drop in the valuation of the company, 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. This may result in a tax cost for the PLC under the Angel Tax provision. 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.

c. ***Interplay of FEMA valuation and Tax FMV under Angel Tax provision not addressed:*** Under FEMA regulations, shares must be issued to non-residents at a value equal to or higher than the FMV whereas the Angel Tax provision prescribes a ceiling value (beyond which there would be adverse tax implications for the issuing PLC). If the FEMA FMV exceeds the Tax FMV by more than the 10% safe harbour limit discussed above, it may not be possible for the PLC to issue equity shares without incurring a tax cost.

d. ***Valuation methodologies under different laws:*** The valuation rules for FEMA prescribe that any internationally accepted valuation methodology may be used whereas for the Angel Tax provision only prescribed methods may be used. It will hence be necessary to use a method that satisfies both FEMA and Angel Tax provision.

e. ***Interplay of deemed income provision with Angel Tax provision not addressed:*** The ITA contains a Deemed Income provision in terms of which if the acquirer buys shares 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 (**Deemed Income**). It may be noted that the valuation rules for Deemed Income provision and Angel tax provision are marginally different. It will now be necessary to compare the valuations for Angel Tax and Deemed Income provisions and understand the impact for the PLC and the investor.

f. ***Exclusion of method D for issue of shares to residents:*** This may cause undue hardship in a transaction as multiple reports will now be required to be obtained in case both residents and non-residents participate in the fund raise by a PLC.

g. ***Certain commonly used methods are excluded:*** Methods like Comparable Transaction Multiple Method, Net Asset Value based on Replacement Cost of assets, etc., are not included in the methods available under the Rules. This causes undue hardship as there can be scenarios where such commonly used methods are more suited for the valuation.

h. ***Combination of valuation methods not allowed:*** The PLC may not be able to use a combination of the above-mentioned methods. It is very common for valuers to give weightage to multiple methods. For example, the valuer may want to attribute 50% to DCF method and 50% to NAV method. This may not be possible under amended Rule 11UA.

i. ***Requirement to have a robust valuation:*** Valuation of shares has always been a litigated issue. In the past, considerable tax litigation was witnessed when only two methods were prescribed. Now with more methods being prescribed, it is expected that litigation will only increase and hence it is very important to have a robust valuation.

j. ***Genuine transactions not excluded:*** The scope of the Angel Tax provision has increased significantly in the recent past. The CBDT should consider excluding additional categories of genuine transactions, given that the provision was introduced as an anti-abuse provision. For instance, in a capital infusion by a holding company to its subsidiary, there is no benefit arising to any third party. Such transactions have not been excluded from the purview of this provision.

4 Looking ahead

The amendments to Rule 11UA should provide relief in terms of flexibility on the valuation date and methods, as well as the safe harbour of up to 10% while calculating the Tax FMV of shares. 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 new valuation methods may also need to be assessed. As the valuation reports will be subject to scrutiny from various tax and regulatory authorities, it is highly recommended to obtain a robust and consistent valuation complying with FEMA, Deemed Income provision and Angel Tax provision.