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S. Rohit Kumar

Himanshu S. Sinha

S. Rohit Kumar is counsel and Himanshu S. Sinha is head of tax practice with Trilegal in India.

In this article, Kumar and Sinha examine the nuanced implications of India's new angel tax for investors, taxpayers, and the overall economic climate.

Inflow and outflow of capital into India is regulated by the Reserve Bank of India. Capital cannot be freely remitted into and outside India. The remittances are subject to satisfaction of valuation principles prescribed by the bank. Similarly, tax laws prescribe valuation rules for issuing and transferring shares. If shares are subscribed or acquired at a value that does not comply with the valuation prescribed under the rules, there are adverse tax implications for the company issuing the shares and the shareholder. This article explores this aspect of Indian law and the various nuances that must be considered when investing in an Indian company.

Origin of the Angel Tax

Around 2010 the Indian tax authorities discovered a trend of privately held companies issuing shares at a high premium with the deceptive motive of converting unaccounted funds of their founders, promoters, and shareholders into legitimate equity capital of the company. To tackle this problem, the Indian income tax law was amended to consider the premium amount to be the taxable income of the company.

The law provides that the premium (defined as an excess of consideration over the fair market value received by a private limited company (PLC) for issuing shares) is deemed to be the PLC's income. This income is considered notional income for the PLC and is taxed at the applicable corporate tax rate. This is commonly referred to as the angel tax and has been the subject of intense debate among the stakeholders. The angel tax rate is 25.17 percent for most PLCs. The FMV is computed by using certain prescribed methods.

Until March 31, 2023, the angel tax provisions were only applicable to share premiums received from resident investors. Originally, the angel tax was intended to target investments from resident investors, but the government, in its wisdom — and without too much explanation — began on April 1, 2023, to extend the applicability of these provisions to nonresidents too.

Recent Developments

This extension to funds raised from nonresidents has caused concern among foreign investors, especially the global financial institutions. PLCs, trade bodies, startups, tax advisers made multiple representations to the Central Board of Direct Taxes (CBDT), the apex tax policy body in India. One key representation was that the prescribed valuation methods were inadequate to value new-age businesses like artificial intelligence, digital technologies, space exploration, cryptocurrency, virtual digital assets, online gaming, and so forth. The CBDT considered these representations and has now

Table 1. Prescribed Methods of Valuation

Method	Particulars
A	Net asset value-based method.
B	Discounted free 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 issuance of shares to another investor within a period of 90 days. The specified funds are venture capital funds, venture capital companies, and Category I and II alternative investment funds.
D	Comparable company multiple (CCM) method, probability weighted expected return method, option pricing method, milestone analysis method, or replacement cost method based on a report by a merchant banker.
E	Price of shares issued by a PLC to a notified investor is considered the tax FMV for issuance of shares to another investor within a period of 90 days. The notified investors are the following entities, which are resident(s) of a specified country: • Category I foreign portfolio investors; • endowment funds associated with universities, hospitals, or charities; • pension funds created or established under the laws of the specified countries; • broad-based pooled investment vehicles or funds with more than 50 investors, provided it is not a hedge fund and does not employ diverse or complex trading strategies. The specified countries are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, the United Kingdom, and the United States.

prescribed new valuation rules for the issue of equity and preference shares to residents and nonresidents, which became applicable September 25, 2023.

Table 1 illustrates the methods of valuation prescribed by the new rules.

Safe Harbor Provisions

The CBDT also provides a safe harbor provision. Under this, for the purpose of angel tax provisions, the issue price will be accepted as the tax FMV if it does not exceed the value computed using the above-mentioned methods by more than 10 percent. This is a welcome exemption as this should help account for foreign exchange fluctuations and commercial bargaining.

The CBDT also allows flexibility on date of the valuation report when considering the valuation date for tax FMV calculation. Under the earlier provisions, the valuation report was required to be obtained precisely on the date the shares were issued. The valuation report can now be obtained up to 90 days prior to the issue date.

Safeguards to Counter Abusive Tax Planning

The CBDT has also built in safeguards against foreseeable strategies that may be used to dodge these rules. For example, PLCs may issue a nominal number of shares to a Category I alternative investment fund or a notified investor and use that valuation as a benchmark for issuing a higher number of shares to a nonresident without genuinely doing a valuation. To counter this, the CBDT has prescribed that the consideration received from issuing shares to a non-notified investor must be limited to the consideration received from the notified investor.

Operational Lacunae

There are various operational lacunae which the CBDT has not accounted for while notifying the above new valuation methods. For example, Method D cannot be used to compute tax FMV for issuing shares to residents. This may cause undue hardship as multiple reports will now be required to be obtained if both residents and nonresidents participate in a share issuance by a PLC.

Certain commonly used methods like comparable transaction multiple method, net asset value based on replacement cost of assets, and so forth are not included in the list of accepted valuation methods prescribed in the rules. This also causes undue hardship because there can be

Table 2. Demonstration of Implications Under Various Provisions

FMV (FEMA/ Angel Tax/ Deemed Income)	Issue Price	Implications Under FEMA	Implications Under Angel Tax Provisions	Implications Under Deemed Income Provisions
INR 100	INR 90	Not permissible under FEMA to issue shares to nonresidents at a price lower than FMV.	No implications as shares are not issued at a price more than the tax FMV.	INR 10 will be taxable for the investor as issue price is lower than the FMV.
INR 100	INR 110	Compliant with FEMA as shares are issued at a minimum of FMV.	No implications as the issue price is in the safe harbor range.	No implications as shares are issued at a price above FMV.
INR 100	INR 120	Compliant with FEMA as shares are issued at a minimum of FMV.	INR 20 will be taxable for the PLC as issue price exceeds tax FMV by more than 10 percent.	No implications as shares are issued at a price above FMV.

scenarios when these commonly used methods are more suited for the valuation of securities.

The rules don't seem to allow a PLC to use a combination of the prescribed methods. It is common for valuers to give weight to multiple methods. For example, the valuer may want to attribute 50 percent to DCF method and 50 percent to net asset value method, which now may be impossible. Also, until September 25, 2023, PLCs were allowed to use any method deemed fit by the merchant banker for valuing preference shares. The merchant banker will now be required to use only the specified methods for this valuation.

Interplaying Valuation Guidelines

Several issues may also arise because of the discrepancies between the angel tax provisions and the Foreign Exchange Management Act, 1999 (FEMA). Under the FEMA and its regulations, shares must be issued to nonresidents at a value equal to or higher than the FMV. However, the angel tax provisions prescribe a ceiling value beyond which there would be adverse tax implications for the issuing PLC. If the issue price, being the FMV, exceeds the tax FMV by more than 10 percent, it may not be possible for the PLC to issue equity shares without incurring a tax cost. Further, Indian tax laws also contain a deemed income provision that if shares are bought for a consideration lower than the FMV computed in the prescribed manner, the excess FMV over that consideration is treated as the share-purchaser's income and taxed accordingly (deemed income). An illustration covering the varied implications that may arise because of these discrepancies is given in Table 2.

Further, under the FEMA regulations, convertible instruments cannot be converted at a price lower than the FMV of the instruments at the time of their issuance. In a scenario with a drop in the valuation of the PLC, the tax FMV of the PLC's shares at the time of conversion may be lower than the FMV of the convertible instruments at the time of their issuance. 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. These situations may result in a tax cost for the PLC under the angel tax provisions.

Judicial Precedent on Conversion of Debt Instruments to Shares

Under the angel tax, the PLC should receive consideration for issuing shares in the year of their issuance. There is a history of litigation on whether conversion of a debt instrument to shares would attract the angel tax because conversion happens in a future year whereas the PLC has received cash consideration against issue of debt instruments in an earlier year. In a recent decision,[1] the courts held that conversion of a debt instrument into equity shares by issuing the shares at a premium would attract the angel tax.

[1] *Keep Learning Resources Pvt. Ltd. v. ITO*, ITA No. 1692/Mum/2023 (ITAT-Mum. 2023).

The courts pronounced that the term "consideration" encompasses consideration in all forms and is not limited to receipt of money. Examples of consideration which PLC "receives" on the conversion of its debt instrument into equity shares include:

- extinguishment of PLC's repayment obligation of the debt;
- release of charge created on the PLC's assets to secure the debt;
- extinguishment of the cost of servicing the debt obligation (i.e., periodic interest);
- the capital base in the form of own fund gets widened to leverage on the capital markets;
- the debt-equity ratio becomes favorable to various stakeholders, making it more investor attractive; and
- the risk of getting into the claim of insolvency resolution from the debt creditors if default in servicing their debt obligation is mitigated.

Accordingly, the courts have held that converting debt instruments into equity shares entails receipt of consideration by the PLC; restricting the ambit of "consideration" only to "receipt of money" will render angel tax provisions futile for all transactions of security conversion. In our view, the rationale given by the courts regarding debt instruments appears to be logical, so investors must evaluate the implications under the angel tax prior to converting debt instruments to shares.

Convert Preference Shares to Equity Shares

Another interesting aspect of the angel tax is the implication of converting preference shares to equity shares. It is common for shareholders to subscribe to compulsorily convertible preference shares because it gives them greater rights compared with equity shares. The terms of these preference shares mandate converting preference shares to equity shares on a future date if certain events occur because of regulatory requirements or because of commercial considerations.

At the time of future conversion, new equity shares are issued, and preference shares are extinguished; however, one may take a view that while there is an issue of shares, there is no receipt of consideration by the PLC because many of the above discussed aspects regarding "consideration" applicable to converting debt instruments to equity instruments are inapplicable to converting preference share to equity share. For example, debt obligations do not exist for preference shares, preference shareholders do not have charge on the assets of a PLC, preference shareholders do not get interest (they get dividends), and so forth.

Depending on the terms of the issuance of preference shares, characteristics of preference shares, and so forth, if it can be proved that there is no consideration received by the PLC on conversion, arguably the angel tax does not apply on conversion to preference shares; however, this view is untested. On a conservative basis, to avoid prolonged litigation, it would be safer to obtain a valuation report on conversion of preference shares and have an impact assessment done.

Judicial Precedent on Valuation Method

Valuation of shares is often litigated in the Indian tax space. In a recent decision,[2] the tax tribunal upheld the tax authorities' approach of rejecting the DCF method used by the valuer for issuing shares based on the following key arguments:

- the valuation done using the DCF method was a hypothetical estimation with no cogent basis;
- highly inflated revenue projections of the PLC were adopted by the valuer as compared with actual revenue of the last three years;
- big variance in projected sales and projected profits;
- no advance taxes were paid in the year of share issuance by the PLC;
- the valuer did not take steps to verify the correctness of the data supplied; therefore, the correctness of the DCF method's result cannot be established.

Notably, tax authorities carry out tax assessments almost three years after the end of the financial year in which shares are issued. At this juncture, they have the benefit of hindsight — actual audited financial statements available to

[2] *M/s MobiCom Technologies Pvt. Ltd. v. ITO*, ITA No. 494/Bang/2023 (ITAT-Mum. 2023).

them, whereas the same are not available to a valuer. The valuation is based on future projections provided by the PLC. In our view, the PLCs may consider the following safeguards for valuation:

- use an alternative method to substantiate the primary method; for example, if DCF is used primarily, use a CCM method to support the DCF;
- use methods other than DCF because multiple methods are now prescribed;
- use realistic projections; and
- should not have too much variance from market practice on growth rates, discount factors, terminal cash flows, etc.

In the past, when there were only two valuation methods prescribed for computing the tax FMV, considerable tax litigation was witnessed on various issues, like method of valuation, date of valuation report, data used for the valuation, assumptions made by the valuer, and so forth. Now, with even more methods being prescribed, it is expected that litigation will only increase. It is important for PLCs to ensure a robust valuation that will withstand the scrutiny of the tax authorities.

Exemptions Possibly Provided by the CBDT

In the larger national interest of making India an attractive hub for foreign direct investment and for promoting investments into start-ups, the CBDT had already exempted notified start-ups from angel tax provisions. Similarly, it may consider extending this exemption to PLCs receiving investments from notified investors from certain other prominent investment jurisdictions (like the United Arab Emirates, Singapore, and Mauritius).

CBDT may also consider extending exemptions to certain other genuine transactions, like capital infusion by a holding company to its subsidiary. In a capital infusion by a 100 percent holding company to a subsidiary company taxing premium received from issuance of equity shares to holding company does not have any merit or logic.

Silver Lining; Tax on Unexplained Credits

There is another antiavoidance provisions under Indian tax law that stipulates that if a PLC that is receiving funds from a resident is unable to prove the genuineness and source of these funds, the PLC will be liable to a whopping 78 percent tax on these funds (tax on unexplained credits). These provisions not only require the PLC to have the information on the source and genuineness of funds but also require the PLC to prove the genuineness and source of the funds used by the investor. Accordingly, PLCs, as a general practice, have been gathering this data from resident investors before accepting their investments to be able to demonstrate the "source of the source" of funds.

Thankfully, the government has not extended the provisions governing the tax on unexplained credits to nonresident investors because it would have been a herculean task for a PLC to collect the information on the source of funds from the nonresidents and such a parallel extension would cause a chilling effect on the investment climate in India.

Conclusion

Extending the angel tax to cover investments from foreign investors is an unwise step which may lead to increased friction, uncertainty, and higher compliance costs. The effort to ameliorate the harshness associated with the new law by prescribing multiple valuation methods, carving out exceptions, providing safe harbor provisions, providing 90-day valuation date flexibility, exempting notified start-ups from angel tax provisions, exempting share issuances to notified funds from angel tax provisions, exempting share issuances to notified investors from angel tax provisions, and so forth would provide some succour to the taxpayers. However, complications still prevail and exemptions for genuine transactions are still awaited. In the interim, it is clear that angels and investors must evaluate all the above nuances to reduce the risks arising from the uncertainties surrounding the new law. ■