Angel Tax – Genesis, Problem, Relief, Conclusion & Way Forward

- Contributed CA Suresh Babu S & CA Sri Harsha
(SBS and Company LLP, Chartered Accountants)

Genesis:

Finance Act, 2012 with effect from 01.04.2013 has introduced a new sub-section to Section 56 (2) of Income Tax Act, 1961 (for brevity 'Act'). The new sub-section (viib) taxes any amount which is received by a company from any person who is resident, any consideration for issuance of shares that exceeds the face value of shares, the aggregate consideration received for such shares as exceeds the fair market value (for brevity 'FMV') of the shares. Section 56(2)(viib) will apply to such companies in which public are not substantially interested.

Further, the said section does not apply, where consideration for issue of shares is received:

- by a venture capital undertaking from a venture capital company/firm[1]
- by a company or class of classes of persons as may be notified by Central Government

The intention of the legislature to introduce Section 56(2)(viib) is to prevent generation and circulation of unaccounted money, which comes into the companies through share capital. The tax authorities tried to tax such consideration which is in excess of FMV of shares vide Section 68 of Act. While they were not successful, a new section namely Section 56(2)(viib) has been introduced to tax such high premiums.

However, the introduction of such section has brought huge problems for 'start-up'. It is common that majority of the investments happen in 'start-up' would be at high premiums because the investor sees what no one else can see. Since Section 56(2)(viib) charges amounts which are in excess of FMV, the 'start-up' community was demanded to pay huge taxes on the premiums received from investors.

Determination of FMV:

Hence, it important to determine the FMV to see whether there is any excess consideration than the FMV of shares as on the date of issue of shares. The said section lays down the method to determine the FMV of shares as under:

- as prescribed in rules[2] or
- as may be substantiated by company to satisfaction of officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know how, patents, copyrights, trademarks, licenses, franchises or any other business or commercial rights of similar nature whichever is higher

Rule 11 UA(2) provides two options for the assesse to choose, which are as under:

- Book Value (BV)
- Discounted Free Cash Flow (DCF)

The book value is arrived by subtracting the liabilities from the assets and dividing by number of equity shares in the company. In other words, the BV method looks at the current assets and liabilities of the company to arrive the FMV of share.

[1] VC undertaking, VC company, VC fund as defined in Explanation to Section 10(23FB).
[2] Rule 11 UA of Income Tax Rules, 1962

On the other hand, the DCF method looks at future cash flows to the company which are discounted at an appropriate discount rate to arrive at the present value of future cash flows. Such cash flows after making certain adjustments are divided by number of equity shares of the company to arrive the FMV of share.

From the above, it is evident that FMV as per BV is current value and FMV as per DCF is the present value of future cash flows. No 'start-up' would choose to value itself under BV method, since substantial assets like research & development and others which can yield potential revenues are not being recognized in the balance sheets as they do not satisfy the definition of 'asset' as per the relevant accounting standards. Hence, the book value would not truly represent the value of company. This leaves the 'start-up' to adopt the DCF method, which is futuristic and not based on today's assets and liabilities.

Ignoring the basic purpose and intent of introduction of Section 56(2)(viib), the tax authorities have made huge demands on 'start-up' for the share consideration received from investors. They have routinely discarded the valuations which are based on DCF method despite of the fact that the said reports are certified by chartered accountants and merchant bankers. The tax authorities have tried to value the company based on BV and proposed demands on the excess of FMV as determined by BV method.

In this article, we attempt to define the problem, the relief, the conclusion and the way forward.

The Problem:

For example, consider a company ABC Private Limited. It has shares of face value Rs 10/-. ABC Private Limited is engaged in development of innovative services. ABC Private Limited was burning cash heavily since majority of the expenditure is pumped into research & development. ABC Private Limited is approached by investor who wants to invest seeing the future of the product which is being developed by ABC Private Limited. Accordingly, after several rounds of negotiation, the value of share is fixed at Rs 350/- per share and investor pumped in funds at such value.

ABC Private Limited has issued 1,00,000 shares at Rs 350/- per share to the Investor. Immediately, the tax authorities propose a demand under Section 56(2)(viib) stating that ABC Private Limited has received consideration for issuance of shares which is more than FMV of shares say Rs 50/- as per BV method. Accordingly, a tax demand was made to the extent of Rs 3 Crores (1,00,000 shares * (350-50) per share).

Now ABC Private Limited has to approach the tax authorities and justify the value of shares as Rs 350/- and not Rs 50/- as proposed by authorities. This will take a good enough time and ABC Private Limited instead of spending time in innovation spends time at Tribunals and Courts to deal with this matter.

This is the acute problem faced by every 'start-up' in India which received consideration from the investor. Investor would not leave a single stone unturned to see that he is not paying more than what the share is worth of. The general ideology of the investor is to invest into the company when it is in young stage and exit when it is in growth stage. Hence, he would not invest more than what the company is worth of. The tax authorities keeping aside all these, propose to tax such excess consideration in the hands of the company who is receiving the monies for issuance of shares.

The Relief:

Central Board of Direct Taxes (for brevity 'CBDT') after examining certain demands raised by tax authorities on 'start-up' community has issued a Circular vide F No 173/14/2018 – ITA dated 6th Feb 2018. The said circular stated that if the assessee is a 'start-up' which falls under the definition given in Notification of DIPP, Ministry of Commerce & Industry, in GSR 501 (E) dated 23.05.2017, the additions

made by assessing officer rejecting the valuation provided by 'start-up', no coercive measure is to be taken to recover the outstanding demand.

It is important to note that the relief given by CBDT does not apply to all start-ups. The relief will be applicable to such 'start-up' which would fit into the definition provided by Ministry of Commerce & Industry. The said Ministry has issued various notifications dealing with definition of 'start-up' from time to time. The various definitions including the current one is discussed as under.

Understanding 'Start-Up'

The Ministry of Commerce & Industry has issued the following notifications dealing with 'Start-Up' as on date:

S No	Notification Number	Date of Notification	Current Status
1	GSR 108 (E)	17.02.2016	Superseded
2	GSR 501 (E)	23.05.2017	Superseded
3	GSR 364 (E)	11.04.2018	Superseded
4	GSR 34 (E)	16.01.2019	Superseded
5	GSR 127 (E)	19.02.2019	Active

For the purposes of this article, let us understand the recognition criteria for a company to be called as 'start-up' in terms of Notification No GSR 127 (E) dated 19.02.2019.

Definition of Start-Up:

An entity shall be considered as a 'start-up':

- Upto 10 years from date of incorporation/registration[3]
- Turnover[4] of entity for financial years since incorporation has not exceeded INR 100 Crores
- Entity is working towards innovation, development or improvement of product or processes or services, or if it is scalable business model with a high potential of employment generation or wealth creation

An entity ceases to be 'start-up' once it completes 10 years or turnover exceeds INR 100 Crores. Eligible 'start-up' should make an application and submit relevant documents to get recognized under this Notification.

Relief from Section 56(2)(viib):

A start-up shall be eligible for exclusion from the provisions of Section 56(2)(viib) by issue of notification by CBDT, only if it fulfils the following conditions:

- Such start-up is recognized under this Notification or earlier notifications issued by Ministry
- ***Aggregate amount of paid up share capital and share premium*** of the start-up after issue or proposed issue of share, if any, ***does not exceed Rs 25 Crores*** and
- It has not invested in specified assets

Let us proceed to understand in detail the above conditions to evaluate the relief from Section 56(2)(viib).

[3] Incorporation/Formation is permitted only in nature of Private Limited Company/LLP/Firm
[4] As defined in Section 2(91) of Companies Act, 2013

Exclusions for arriving INR 25 Crores:

One of the conditions to claim exemption from Section 56(2)(viib) is that the aggregate amount of paid up share capital and share premium of the start-up after issued or proposed issue does not exceed Rs 25 Crores.

In order to arrive the said amount of Rs 25 Crores, the notification excludes teh amount of paid up share capital and share premium in respect of shares issued to the following persons:

- non-resident
- venture capital company or venture capital fund
- specified company[5]

Investments in Specified Assets:

One of the conditions to claim exemption from Section 56(2)(viib) is that such start-up should not invest in following assets for a period 7 years from the end of latest financial year in which shares are issued at premium:

- building or land appurtenant thereto, being residential house other than that used by Startup for purposes of renting or held by it as stock-in-trade, in the ordinary course of business
- land or building or both, not being a residential house other than that used by Startup for its business or used by it for purposes of renting or held by it as stock-in-trade, in the ordinary course of business
- loans and advances, other than loans and advances extended in the ordinary course of business by the Start Up where the lending of money is substantial part of its business
- capital contribution made to any other entity
- shares and securities
- motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds Rs 10 lakhs other than that held by the Startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business
- jewellery other than that held by the Startup as stock-in-trade in the ordinary course of business
- Any other asset, whether in nature of capital asset or otherwise, of the nature of archaeological collections, drawings, paintings, sculptures, any work of art or bullion.

If Start-up is found to invest within a period of 7 years from the date of issue of shares at premium, the exemption under Section 56(2)(viib) will be revoked with retrospective effect.

The Conclusion:

[5] Specified company means company whose shares are frequently traded within the meaning of SEBI (SAST) Regulations, 2011 and whose net worth on the last date of FY preceding the year in which shares are issued to them exceeds Rs 100 Crores or turnover exceeds Rs 250 Crores.

From the above, it is evident that both CBDT and Ministry were consistently putting efforts to strike a balance between the start-up eco system and tax revenues. The start-ups accepting consideration towards issue of shares has to examine the relevant conditions are not violated so that they are not burdened with the tax demands.

Further, for companies other than start – ups which are not fitting into the notification and thereby not recognised by Ministry will continue to face challenges from the tax authorities. The blanket rejection of valuation adopted by merchant bankers or chartered accountants[6] by the tax authorities is unwarranted and does hamper the young companies. Since Section 56(2)(viib) is only applicable to resident investors, the companies who are seeking investment are looking towards non-residents to avoid the unnecessary clutches of this provision.

It is also important to note that merchant bankers who are issuing the valuation certificates based on DCF has to adopt the principles of International Valuation Standards to pass the test of the tax authorities. The Mumbai Income Tax Appellate Tribunal in the matter of Madhurima International Private Limited[7] has held that Assessing Officer has failed to examine the valuation report which was issued by Chartered Accountant which does not comply with the minimum standards prescribed by Institute of Chartered Accountants of India and held that action of Commissioner under Section 263 of Act is justifiable.

In addition to the above, the tax authorities have also to bear in mind, the words passed by the Honourable High Court of Bombay in matter of Cadbury India[8] on the aspect of valuation:

7.1.10 Valuation is not an exact science. Far from it. It is always and only an estimation, a best judgment assessment. The fact that a particular estimation might not catch an objector's fancy is no ground to discredit it. All valuations proceed on assumptions. To dislodge a valuation, it must be shown that those assumptions are such as could never have been made, and that they are so patently erroneous that the end result itself could not but be wrong, unfair and unreasonable. The court must not venture into the realm of convoluted analysis, extrapolation, and taking on itself an accounting burden that is no part of its remit or expertise, and no part of a statutory obligation. In particular, the court must guard against the seductiveness of a proposition that suffers from the fallacy of the undistributed middle: all x is z; some y is z; ergo, all y is z. The errors and consequent unreasonableness must be shown to be patent and self-evident

7.1.11 It is impossible to say which of several available valuation models are "best" or most appropriate. In a given case, the CCM method may be more accurate; in another, the DCF model. There are yet others. No valuation is to be disregarded merely because it has used one or the other of various methods. It must be shown that the chosen method of valuation is such as has resulted in an artificially depressed or contrived valuation well below what a fair-minded person may consider reasonable.

Hence, there is abundant necessity on merchant banker or concerned to issue valuation report based on International Valuation Standards and the tax authorities on the other hand should not just reject based on the premise that he is not able to believe the estimate of the value of share. The tax authorities should only reject valuation if the fundamental assumptions used in the valuation report are erroneous and not for the reason that they could not believe that estimate is true.

The Way Forward:

[6] Prior to removal of 'chartered accountant' from the definition of 'accountant'
[7] 2017 (5) TMI 58 – ITAT Mumbai
[8] Company Petition 1072/2009, 1332/2009, 71/2010 and 120/2010

The Ministry in the current notification stated that it will revise the notification whenever a need arises on or before 31.03.2021. We hope that out of the experience gained by the Ministry in implementing this notification, the turnover limits or years or aggregate amounts of share capital and premium might be revised upwards to accommodate more genuine start-ups in the ambit of exemption of Section 56(2)(viib). All other start-ups have an inherent duty to see that valuation reports would reflect true picture to avoid the clutches of Section 56(2)(viib). The CBDT has to examine all the matters all over India on this section and issue necessary instruction to assessing officers detailing the procedure to be adopted as to when a valuation report can be rejected and what should be the modus operandi when assessing officer believes that valuation report is erroneous. This will clear the air and reduce the number of start-ups facing the tax burden.