ANGEL TAX VALUATION RULES NOTIFIED

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Background

By its notification dated September 25, 2023, the Central Board of Direct Taxes (CBDT) has amended Rule 11UA of the Income-tax Rules, 1962 (the "**IT Rules**") which provides the manner of computing the fair market value ("**FMV**") of unlisted equity shares and compulsorily convertible preference shares ("**CCPS**") under Section 56(2)(viib) of the Income-tax Act, 1961 (the "**IT Act**").

Section 56(2)(viib) of the Income-tax Act, 1961, popularly known as the "Angel Tax" provision, applies when a company in which the public are not substantially interested (i.e., a private company or an unlisted public company) issues shares at a premium and receives consideration that is more than the FMV of the shares. The excess amount received is deemed as income from other sources in the hands of the company. Prior to April 1, 2023, Angel Tax was only applicable on shares issued to Indian tax residents; however, it has now been made applicable for shares issued to non-residents as well.

The amendments to Rule 11UA of the IT Rules offer taxpayers some flexibility in the choice of valuation methods and incentivizes venture capital investments. We have discussed the amendments in brief below.

Types of valuation methods

At present, the FMV of unlisted equity shares can be calculated using either of the following methods, at the option of the issuer company: (i) Book-value based Net Asset Value Method ("**NAV Method**"); or (ii) Discounted Free Cash Flow Method ("**DCF Method**"). In addition to the existing methods, the issuer company can now choose any of the following methods:

1. Methods applicable only for shares issued to non-resident investors: Five (5) new valuation methods have been introduced to value shares issued for non-resident investors. They are: (i) Comparable Company Multiple Method; (ii) Probability Weighted Expected Return Method; (iii) Option Pricing Method; (iv) Milestone Analysis Method; and (v) Replacement Cost Method (collectively, the "**NR Valuation Methods**"). The computation under these methods must be done by a category I merchant banker registered with Securities and Exchange Board of India.

2. Methods applicable in case of a Venture Capital Undertaking issuing equity shares, *inter alia*, to a Venture Capital Fund, Venture Capital Company or Specified Fund (defined below) (collectively, "**VC Investors**"): The price at which equity shares are issued to VC Investors can be taken as the FMV of equity shares, and other investors can be issued equity shares at this FMV within ninety (90) days before or after the date of issue of shares to the VC Investors, but up to the aggregate consideration received from the VC Investors.

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Therefore, the valuation method adopted at the time of VC Investors' investment can be taken as a benchmark for other investors' investment within the ninety (90) day period. For example, if a Venture Capital Undertaking (VCU) receives a consideration of INR50,000 from a Venture Capital Company (VCC) for issue of 100 shares at the rate of INR500 per share, then the VCU can issue 100 shares at INR500 to any other investor within a period of ninety (90) days before or after the receipt of consideration from the VCC. A "Specified Fund" means a Category I or Category II Alternative Investment Fund regulated under the Securities and Exchange Board of India (Alternative Investment Fund) Regulations, 2012 or International Financial Services Centre Authority (Fund Management) Regulations, 2022.

3. Methods applicable in case equity shares are issued to non-resident investors notified by the Indian government ("**Notified Investors**"): The price at which unquoted equity shares are issued to Notified Investors can be taken as the FMV of equity shares, and other investors can be issued equity shares at this FMV within ninety (90) days before or after the date of issue of shares to the Notified Investors, but up to the aggregate consideration received from the Notified Investors. Therefore, the valuation method adopted at the time of Notified Investors' investment can be taken as a benchmark for other investors' investment within the ninety (90) day period.

"Notified Investors" have been specified in Notification No. 29/2023 dated May 24, 2023 which lists the categories of persons whose investments are not subjected to Angel Tax like: (i) government and government-related investors; (ii) banks or regulated entities involved in the insurance business; and (iii) the following categories of investors resident in any one of twenty-one (21) notified jurisdictions and regulated by such jurisdiction, namely, category-I foreign portfolio investors, endowment funds, pension funds, and broad-based pooled investment vehicles or funds. Notably, the twenty-one (21) notified jurisdictions exclude certain popular intermediary jurisdictions from which foreign investment is made into India, such as Mauritius, Singapore, The Netherlands and the UAE.

4. Valuation methods notified for CCPS: The FMV of CCPS' can be computed using the DCF method or any of the new valuation methods discussed in paragraphs 1, 2 and 3 above based on the type of investor or based on the FMV of unlisted equity shares determined as per the NAV Method, DCF Method or any of the new valuation methods discussed in paragraphs 1, 2 and 3 above based on the type of investor.

Valuation date: The erstwhile Rule 11UA required a merchant banker's valuation report as on the date of issue of shares. The amended Rule 11UA provides that a valuation report issued up to ninety (90) days prior to the date of issue of equity shares or CCPS can be used for computing the FMV for investments by both, resident and non-resident investors.

Safe Harbour: The amended Rule 11UA provides for a safe harbour FMV tolerance limit of 10%. Thus, if the issue price does not exceed the FMV as per the prescribed methods (NAV Method, DCF Method or NR Valuation Methods) by more than 10%, the issue price shall be deemed to be the FMV. Note that this this relaxation is not available for share issuances to VC Investors or Notified Investors under paragraphs 2 and 3 above.

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Applicability to startups: The Angel Tax provisions are also applicable to startups who receive investments from non-residents. Currently, only startups that fulfil the conditions specified by the Department for Promotion of Industry and Internal Trade as per paragraph 4 of its Notification No. G.S.R 127(E) dated February 19, 2019 and file a self-declaration to this effect are exempted (by Notification No. 30/2023) from the Angel Tax provisions.

Comments

These are welcome measures, but at the ground level, Indian companies continue to receive scrutiny and assessment notices from the Indian tax authorities seeking justification for share premiums received and the valuation method used to calculate the FMV of shares. Indian tax authorities are known to take aggressive positions and have either challenged the valuation methodology adopted by a valuer or the underlying assumptions made in determining the valuation. The focus has been to augment the tax base and impose taxes on any case of undervalued share issuance by treating it as income from other sources. We had covered a tax case where the revenue department refused to accept the NAV method valuation (to read click here).

As valuation is a subjective matter, a variety of valuation methods with different approaches may still lead to litigation risks. A better approach may have been to let businesses operate freely but seek additional information in a company's tax return on how premium has been calculated and whether it is market standard for such a company or business taking into account international and Indian valuation standards. Unless the Indian tax authorities are trained on valuation norms, reducing indiscriminate tax scrutiny will be difficult.

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