CONCEPT OF ANGEL TAX & ITS IMPACT ON START-UPS

INTRODUCTION:

After the controversial angel tax was imposed in the Union Budget for 2023-2024, media reports claim that the Union government will soon issue draft rules in a week to address taxation and valuation concerns expressed by start-ups and investors.Start-ups are now confronting a funding crunch because of increasing loan fees across the globe. In addition, the ecosystem is experiencing a decrease in PE[1] and VC[2] investments and is concerned that changes to the angel tax's terms may discourage international investments.Angel Tax is a tax levied on investments made by Angel investors[3] in start-ups to prevent money laundering through the issue of shares at a premium valuation.

The execution of the Angel Tax will affect investment made by foreign investors. Indian start-ups that raise fund from global investors will confront Angel Tax. As a result, more businesses may choose to relocate their operations outside the country, limiting funding for the sector."The foreign investors who were previously exempt from the application of the angel tax have now been bought under the ambit of angel tax," stated Mr. Manish Khanna[4]. An angel tax is imposed in accordance with Section 56.2.VII B[5] of the Income Tax Act of 1961 if the share price that is distributed to investors is greater than the share's FMV[6].

However, the introduction of an angel tax will eliminate the tax gap between residents and non-residents, as resident investors have always been subject to taxation.

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[1] Private Equity
[2] Venture Captial
[3] Angel investors are the individuals who have high-net-worth and invest their personal income in business start-ups or small and medium-scale companies.
[4] Co-founder of unlisted Assests
[5]Share premium in excess of the Fair Market Value to be treated as Income.
[6] Fair market Value

NEW PROPOSED ANGEL TAX –

- Prior to proposal in budget 2023-24, Angel Tax was imposed only on investments made by a resident investor.
- As per the new proposal if any Indian unlisted company receives an excess premium from foreign investor, such premium is considered as Income from other sources and will be subject to tax.
- Pursuant to the new proposal, amendment is required in the Finance Bill, 2023 and section 56(2) VII B of Income Tax Act has to be amended.

IMPACTS OF NEW PROPOSAL–

- From foreign investor Indian start-ups can get a major source of funds.
- Start-ups may be frightened as a result of the impact of the angel tax on the company's fair market value. Market value is determined by the company's net assets by the tax department. However, the startup's fair market value is determined by its estimated growth prospects and future projections based on these growth prospects.
- Because the proposal was made in response to the decreasing trend in start-ups' funding, it may have an effect on startup funding. When compared to the previous year, the value of Indian start-ups decreased by 33% to $24 billion in 2022.
- The proposal may also have an effect on the FDI that we receive from these foreign investments. Additionally, investors might not want to deal with additional tax liability while investing in a startup

IMPORTANCE OF NEW RULES –

- The progressions will urge wealthy people to put resources into new companies that get capital at a higher cost than expected by virtue of their inventive plan of action albeit the valuation isn't legitimate by the physical assets they hold.
- The new start-ups, which are in desperate need for capital to fund their growth, can now work smoothly.
- The impact of this new rules are applicable retrospectively, therefore many new start-ups which received notices from the IT[7] department previously, will be relieved by the latest tweak in the rules.

APPREHENSIONS-

- To use the latest exemption, companies required to get registered with the government as start-ups. And to be considered as start-ups, such companies have to meet with certain conditions like it haven't invested in land unrelated to the business, in jewellery or in vehicles worth more than Rs. 10 lakh.
- These abovementioned condition which are supposed to prevent money-laundering, can lead to rent-seeking or bureaucratic delays. Additionally, new rules for angel tax can cause the arbitrary demands for tax of companies which are not defined under start-ups category.
- Shares that aren't openly traded in the market can't be known by their market value. Therefore, tax authorities with dubious motives can continue to harass startups with unreasonable tax demands. Unless the government does something about the arbitrary nature of this angel tax, the damage to investor confidence may continue.

[7] Income Tax

GOVERNMENT TO INRODUCE DRAFT RULE FOR VALUATION AND ANGEL TAXATION -

The government may accept the valuation formula used under FEMA for the angel tax on investments made by foreign investors in startups to provide clarity and end tax conflicts.

Mr. Amit Pamnani[8], said "The suggested approach aims to establish a more objective framework for calculating the FMV of shares by taking into account a number of variables, such as the startup's financial projections, market conditions, and comparable transactions. Consequently, the income tax division will find it easier to determine the shares' fair market value and the valuation process will become more transparent. In the long run, standardizing the valuation procedure will help create a favorable environment for the startup ecosystem".

The government is likely to exempt funds like Abu Dhabi Investment Authority, Qatar Investment Authority, and GIC from the potential impact of Section 56.2.VII B[9] tax on foreign investments.

The FEMA[10], which is run by the RBI, accepts an arm's-length valuation from a Category 1 merchant banker registered with the SEBI[11] using any of the internationally recognized pricing methods. Among other options, the tax authorities are thinking about using the same method for the angel tax.

[8] Chief Investment Officer for Investment Banking at Swastika Investmart
[9] Share premium in excess of the Fair Market Value to be treated as Income.
[10] Foreign Exchange Management Act.
[11] Security Exchange Board of India.

CONCLUSION

Government authorities said that administration had done broad counsel with every one of the associations and have presented their ideas to the ministry of finance. The draft would resolve the issue of contrasts as far as valuation strategy utilized under the Income Tax act and the Foreign Exchange Management Act (FEMA). And for the clarity and to end the tax conflicts, the government may accept the valuation formula used for the angel tax on foreign investment in start-ups.

Furthermore, for standardizing the valuation method the government is set to propose draft rule under Income Tax Law and FEMA[12]. Thus, acquisition costs will be similar for domestic and foreign institutional investors. The angel tax may temporarily defer foreign institutional investment, but it will not discourage foreign investment.

Angel investors who want to buy shares in a start-up must meet certain requirements, and the start-ups must get a report from a merchant banker or Chartered accountant stating the fair market value of the shares in accordance with income tax regulations. According to the income tax notice, angel investors with the minimum net worth of INR 2 crore or the average returned the income of more than INR 25 lakhs in the past 3 monetary years will be qualified for 100 % charge exclusion on the investment that are made in the start-ups over the fair market value.

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[12] Foreign Exchange Management Act.
[13]Majesty legal is law firm, established in 2013 by Ms. MahiYadav and aim of the present article is to provide insights on law and statutes. The opinion presented in the article is personal in nature and not to be deemed as legal advice.