

## ERGO

*Analysing developments impacting business*

### PROPOSALS FOR RELAXATION OF VALUATION RULES FOR ANGEL TAX PROVISION

26 May 2023

#### *Introduction:*

As per Indian tax laws<sup>1</sup> ("ITL"), any 'excess premium' received by an Indian closely held company ("ICo") upon allotment of shares (equity or preference shares) to resident or non-resident investors (unless exempted) is taxed as ordinary income of ICo ("Angel Tax Provision"). The 'excess premium' will be the difference between the consideration received by the ICo for share issuance and the prescribed fair market value of such shares ("Tax FMV").

While this provision was originally applicable only to issuance to resident investors, from 1 April 2023, the Angel Tax Provision was also extended to non-resident investors and hence, led to deliberations with the Government. The Central Board of Direct Taxes<sup>2</sup> ("CBDT") has issued a Press Release dated 19 May 2023 ("Press Release") proposing certain liberalisation measures for determining Tax FMV, and also proposes the introduction of certain further exemptions and reliefs. The CBDT clarified that the draft rules for these proposals will be released for public comments and thereafter corresponding amendments will be notified.

#### *Key proposals in Press Release:*

1. Valuation methods for computing the Tax FMV: Currently, the Tax FMV is computed as higher of:
  - (i) Value based on assets (including intangible assets being goodwill, know-how, etc.) to be substantiated by the taxpayer; or
  - (ii) Value determined basis the following prescribed valuation methods: (a) For equity shares: Net Asset Value ("NAV") or Discounted Free Cash Flow ("DCF") methods), at the option of the ICo; and (b) For preference shares: value it would fetch if sold in open market.

Now, in addition to NAV and DCF valuation methods, the CBDT has proposed 5 new valuation methods for shares to be issued to non-resident investors. It will be interesting to see if new valuation methods will be restricted to equity shares

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<sup>1</sup> Income Tax Act, 1961 read with Income Tax Rules, 1962

<sup>2</sup> Apex body of direct tax administration in India

or will also be extended to preference shares, and whether they will also apply for resident investors.

2. Exemption: Presently, venture capital funds, specified funds, and certain eligible start-ups are exempt from Angel Tax Provision. Now, the CBDT has proposed to grant exemption for investment by following non-resident investors as well:

- (i) government and government related investors<sup>3</sup>;
- (ii) banks or entities involved in insurance business which are governed by applicable regulations in their home country<sup>4</sup>; and
- (iii) any of the following entities which are resident of certain countries or specified territories<sup>5</sup> having robust regulatory framework: (i) entities registered<sup>6</sup> as Category-I Foreign Portfolio Investors; (ii) endowment funds associated with university, hospitals or charities; (ii) pension funds established under the law of the foreign country or specified territory; and (iv) broad based pooled investment fund where the number of investors are more than 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

It is expected that further clarity will be provided in relation to above – especially on aspects such as whether these entities have obtained registration and are regulated in their home country should suffice, point of time at which the aforesaid conditions (such as restriction of number of investors in a fund or not being a hedge fund, etc.) are to be evaluated, etc.

3. Date of valuation report: Presently, the Tax FMV is to be tested as on the date of allotment. Now, the CBDT has proposed that the valuation date can be a prior date, provided: (i) such date is not exceeding 90 days before the date of allotment; and (ii) the report is issued by a merchant banker. The Press Release is silent on whether it is applicable to: (i) resident and non-resident investors: and (ii) equity shares or preferences shares.

4. Tolerance Limit: Presently, the ITL does not provide for any tolerance limit. Now, the CBDT has proposed to provide a safe harbour tolerance limit of 10%, i.e., the price of allotment of shares can be a maximum of 10% above the Tax FMV. This is meant to factor in valuation differences arising out of forex fluctuations, bidding processes and variations in other economic indicators, etc., which may affect the valuation of equity shares during multiple rounds of investment. Further, whether the tolerance limit appears to apply for resident and non-resident taxpayers needs to be seen.

5. Exemption to Department for Promotion of Industry and Internal Trade (“DPIIT”) recognized start-ups: The CBDT has proposed to extend exemption from Angel Tax Provision wherein investment is made in start-up recognized by DPIIT.

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<sup>3</sup> Such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more.

<sup>4</sup> Country where the non-resident entity is established or incorporated or is a resident.

<sup>5</sup> The Central Government has notified list of 21 countries such as United States, United Kingdom, Australia, Germany, etc. (which does not include Singapore, Mauritius, Netherland, Cayman, Luxembourg, UAE, etc.) as specified territory.

<sup>6</sup> Registered with Securities and Exchange Board of India

6. Price matching facility for resident and non-resident investors: The CBDT has proposed to provide a mechanism for alignment of price of equity shares issued with the price at which such shares were issued to certain notified non-resident entities or venture capital funds or specified funds, subject to fulfilment of certain conditions. More clarity on this proposal is expected once the draft rules are notified.

*Conclusion:*

The move to create a ceiling of Tax FMV on investments by non-resident investors was heavily debated as reducing access to capital for Indian businesses. Enhancing foreign direct investment has been a stated objective of the Government for the last several years, and all other legislations (including, the Companies Act, 2013 and the Foreign Exchange Management Act, 1999) also require valuation, but specify that the fair market value computed therein should be the floor and not the ceiling and per those other legislations, parties are free to agree on a higher investment amount basis mutual assessment of commercial potential of an investment.

In this backdrop, the proposed relaxations will provide some respite and relief, and the consultative approach with stakeholders will definitely be appreciated. However, the fine print of the draft rules needs to be closely watched for further clarity. With these changes, the importance of a sharp and precise valuation exercise especially in M&A transactions assumes evermore greater significance and it will be imperative to ensure that the valuation (depending on the nature of instrument such as equity shares or convertible instruments, etc.) is undertaken in line with prescribed tax valuation norms.

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