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VALUATION RULES FOR ANGEL TAX AMENDED

28 September 2023 **Introduction**

In an important income-tax related development, the Central Board of Direct Taxes (CBDT) has issued a notification¹ (Notification) to amend Rule 11UA of the Income-tax Rules, 1962, which prescribes the manner of computing the fair market value (FMV) of shares, in relation to *inter alia* 'Angel Tax' [income-tax levied on excess share premium (i.e. FMV *minus* issue price) received by a closely held Indian company on issuance of its shares]. The updated Rule 11UA provides: (i) flexibility in terms of more options of valuation methods (with specific applicability to compulsorily convertible preference shares) and the relevant date for which valuation report is to be obtained; and (ii) a safe harbour or a tolerance band of 10% (ten percent) differential in certain scenarios (Updated Rule 11UA). Notably, prior to 1 April 2023, Angel Tax was applicable on shares issued to Indian tax residents only; however, w.e.f. 1 April 2023, it applies on shares issued to non-residents also.

Existing Rule 11UA:

1. FMV of equity shares can be computed using either of the following methods, at the option of the issuer company (Existing Methods):
 - 1.1 Book-value based Net Asset Value method (NAV Method); or
 - 1.2 Discounted Free Cash Flow Method (DCF Method).
2. For preference shares, FMV shall be the price it would fetch if sold in the open market.
3. Further, the existing Rule 11UA required computation of FMV on the share issuance date.

Key amendments made to Rule 11UA:

1. **Additional valuation methods for equity shares:** In addition to the Existing Methods (*supra*), the Updated Rule 11UA gives an option to the issuer company to choose any of the following methods also:
 - 1.1 Where a venture capital undertaking (VC Undertaking)² issues shares inter-alia to a venture capital fund or a venture capital company or a specified fund² (Specified Investors) [VC Method]: The price at which equity shares are issued to Specified Investors can be treated as the FMV of equity shares issued to other investors to the extent aggregate consideration received from other investors does not exceed aggregate FMV of shares issued to Specified Investors*. In other words, the valuation used at the time of Specified Investors' investment can be taken as a benchmark for other investors' investment also. For this purpose, the Notification provides the following illustration:

¹ Notification No 81/2023 dated 25 September 2023

² The terms "venture capital company", "venture capital fund", "venture capital undertaking" and "specified fund" are defined under Section 56(2)(viib) of the Income-tax Act, 1961

“Illustration: If a venture capital undertaking receives a consideration of fifty thousand rupees from a venture capital company for issue of one hundred shares at the rate of five hundred rupees per share, then such an undertaking can issue one hundred shares at this rate to any other investor within a period of ninety days before or after the receipt of consideration from venture capital company.”

- 1.2 Where shares are issued inter alia to prescribed investors (Notified Investors)³ [Notified Investor Method]: The price at which equity shares are issued to Notified Investors can be treated as FMV of equity shares issued to other investors to the extent aggregate consideration received from other investors does not exceed aggregate fair value of shares issued to Notified Investors*. In other words, the valuation used at the time of Notified Investors’ investment can be taken as a benchmark for other investors’ investment also.

**Both VC Method and Notified Investor Method can be opted only if consideration is received from Specified Investors / Notified Investors, as applicable, within 90 days (before or after) from the date of issue of shares to other investors.*

- 1.3 Residuary Methods (applicable only for shares issued to non-resident investors): For equity shares issued to non-resident investors, one more additional valuation approach has been prescribed in the Updated Rule 11UA. The FMV can be computed using any of the following methods (computed by a merchant banker): (i) Comparable Company Multiple Method; (ii) Probability Weighted Expected Return Method; (iii) Option Pricing Method; (iv) Milestone Analysis Method; (v) Replacement Cost Method.

2. Valuation methods notified for Compulsorily Convertible Preference Shares (CCPS):

- 2.1 Per the Updated Rule 11UA, FMV of CCPS for Angel Tax provisions can be computed using: (a) DCF Method; or (b) VC Method (if CCPS are issued by a VC Undertaking to inter-alia Specified Investors); or (c) Notified Investor Method (if CCPS are issued to inter-alia Notified Investors); or (d) Residuary Method (available only where CCPS are issued to a non-resident investor).
- 2.2 Alternatively, FMV of CCPS can be computed based on FMV of equity shares using any of the aforesaid prescribed methods for valuation of equity shares.

3. **Valuation Date:** Updated Rule 11UA provides an option to the issuer company to undertake the FMV valuation as on any day up to 90 (ninety) days prior to the share issuance date. However, it is pertinent to note that this flexibility is available only where a report is required from a merchant banker (i.e. for DCF Method and Residuary Method). Consequently, if the taxpayer opts for NAV Method, the valuation will still need to be undertaken as on the share issuance date only.

4. **Safe Harbour:** Updated Rule 11UA has also introduced a tolerance range of 10% i.e. if the issue price does not exceed the FMV as per prescribed method (NAV method, DCF method and Residuary Method) by more than 10%, the issue price shall be deemed to be the fair value. It is pertinent to note that this relaxation is not available where the valuation method adopted is VC Method or Notified Investor Method.

Comment:

Indian companies have in the past received notices from Indian tax authorities seeking justification for share premiums, leading to considerable Angel Tax related litigation. The Updated Rule 11UA accords a great deal of flexibility (in terms of the prescribed valuation methods, relevant date for undertaking valuation, safe harbour / tolerance range of 10%) to Indian companies looking to raise capital. Further, notifying valuation methods for CCPS is

³ The CBDT vide notification no. 29/2023 dated 24 May 2023 has notified certain class of investors, such as government and government-controlled entities, banks, entities involved in insurance business, Category-I FPIs / specified endowment funds / pension funds etc. from 21 specified jurisdictions.

also a welcome step, given that a sizeable portion of funding happens through the CCPS route – that said, valuation of other categories of preference shares continues to be open market value based. Such welcome steps should aid Indian companies to negate the subjectivity element that is embedded in valuing growth-phase companies, thereby reducing the Angel Tax related litigation.

Notably, the Updated Rule 11UA is effective from 25 September 2023. Hence, it will be interesting to see the fate of shares issuances undertaken prior to this date, especially since w.e.f. 1 April 2023, Angel Tax has been made applicable for shares issued to non-residents as well.

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