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news flash
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Taxation of a Non-resident – Vol III

Investments in India – Angel Tax Valuation rules notified!!

Background

Section 56(2)(viib) of the Income Tax Act, 1961 ('**IT Act**') or 'Angel Tax', as it is popularly known, was amended vide the Finance Act, 2023 to include non-residents within its ambit, and seeks to tax any premium received by a company (other than a public listed company), exceeding the fair market value ('**FMV**') of shares issued in the hands of the company.

However, such amendment brought with it possible conflict with the valuation rules as prescribed by the exchange control regulations and prescribed methodology under the IT Act. Please refer to our previous newsflash 'Taxation of Non-resident – Vol I here for details on the valuation conundrum.

The manner of calculation of FMV under section 56(2)(viib) is prescribed under Rule 11UA of the Income Tax Rules ('**IT Rules**') which provided for only 2 methods of valuation viz. the Net Asset Value ('**NAV**') method and the Discounted Cash Flow ('**DCF**') method; whereas the exchange control regulations do not restrict it to these two methods but allow for any internationally accepted valuation methodology.

Therefore, the industry made several representations raising concerns that genuine non-resident investors may have to face undue hardship in matters related to valuation of shares particularly since the exchange control provisions under the Foreign Exchange Management Act, 1999 ('**FEMA**') allows flexibility to use any internationally recognised valuation method. Taking the above into consideration, the Central Board of Direct Taxes (**'CBDT'**) issued draft rule 11UA providing additional valuation methodologies, safe harbour provisions etc., which was open for public comments / consultation till 5th June 2023. Please refer to our previous newsflash 'Taxation of Non-resident – Vol II here for details on the draft rules issued for public consultation.

The CBDT has now formally notified the amended rule 11UA after considering the public comments/ consultation, vide the Income-tax (Twenty first Amendment), Rules, 2023 on 25 September 2023, effective immediately from the date of the notification. In Volume II of the series, we have briefly touched upon the important amendments proposed to be brought about in rule 11UA of the IT Rules. In this volume, we elaborate further on these now that the amendments have been formally notified.

Amendments to Rule 11UA

The changes notified in the amended Rule 11UA are summarised as follows:

1. Introduction of new valuation methods

In addition to the existing NAV and DCF methods, 5 (five) additional valuation methodologies have been prescribed for computing the FMV of unquoted equity shares that are being subscribed to by non-residents:

- Comparable Company Multiple Method;
- Probability Weighted Expected Return Method;
- Option Pricing Method;
- Milestone Analysis method; and
- Replacement Cost method.

Thus, there are now seven prescribed valuation methods, and the company can choose any of these to arrive at the FMV of the equity shares being issued.

2. Valuation methodologies for compulsorily convertible preference shares (CCPS)

Conspicuously absent from the draft rules, the valuation methodology for CCPS, a common investment instrument for foreign investments in India, now makes a show in the notified rules. The rules now provide for valuation methodologies (including the 5 newly introduced methods as described above) for determining the FMV of CCPS as well.

3. Price matching facility

If a company receives any consideration for the issue of equity shares from a notified non-resident entity[1]/ venture capital fund/ specified fund, the price of the equity shares corresponding to such consideration, may be taken as the FMV of the equity shares for other investors (both residents as well as non-residents) as well, if receipt of consideration is within a window of 90 days before or after the date of issuance of shares subjected to valuation.

Extension to CCPS – The amended rules extend the flexibility of price matching facility to issue of CCPS as well, in addition to unquoted equity shares.

4. Time limit for valuation report

The rules provide flexibility by stating that the valuation report (which must be issued by a SEBI registered merchant banker) is valid for a period of up to 90 days and hence the issue of shares can be done at any time within 90 days from the date of the valuation report. This is especially welcome because earlier the valuation report had to be provided as on the date of issue of shares which was a source of problems in finalisation of documentation.

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[1] The notified entities include entities such as government and government related investors, banks or entities involved in insurance business, specified entities from notified countries etc., as specified under clause (ii) of the first proviso to section 56(2)(viib) – please refer to volume I of this news flash series for further details.

5. **Safe Harbour**

The rules provide for an allowance of a 10% variance between the issue price and the FMV arrived at as above. This safe harbour has been extended to equity shares as well as CCPS, and to residents and non-residents alike.

It must be noted that the variance (safe harbour) benefit will only be allowed for FMV computed as per the valuation methodologies prescribed and not for FMV determined as per the price matching mechanism for notified entities or venture capital undertakings, as discussed in point (3) above.

Conclusion

The amended Rules do, to a large extent, strike a balance between the government's objective for widening the tax base and increasing transparency with the additional burden placed on foreign investments being subject to the Angel Tax provisions. This burden was especially difficult to discharge given that the pricing guidelines under FEMA provide flexibility in choice of valuation methods and require the investment to be made at a minimum of the FMV. The applicability of Angel Tax to non-residents effectively resulted in the valuation for FEMA purposes and tax purposes needing to exactly match and the income tax valuation methods being restricted only to NAV and DCF, created a major hurdle.

Now, with clear and concise rules in place, the ambiguity surrounding the need to exactly match valuations under the IT Act with the pricing guidelines under the exchange control regulations can hopefully be put to rest, especially with the additional valuation methods and the safe harbour provisions.

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