news flash

June 2023

Taxation of a Non-resident – Vol II

Investments in India – Draft rules on Angel Tax

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. 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. Net Asset Value (‘**NAV**’) method and the discounted cash flow (‘**DCF**’) method; whereas exchange control regulations do not restrict it to these two methods but allow for any internationally accepted valuation methodology. Please refer to our previous newsflash ‘Taxation of Non-resident – Vol I here for details on the valuation conundrum.

Therefore the industry made several representations raising their concerns that genuine non-resident investors may have to face undue hardship in matters related to valuation of shares etc. Taking the above in consideration, the Central Board of Direct Taxes (**‘CBDT’**) has issued draft rule 11UA providing additional valuation methodologies, safe harbour provisions etc., which is open for public comments / consultation till 5th June 2023.

Draft Rule 11UA – proposed amendments

The key proposed amendments in the draft rules in relation to applicability of section 56(2)(viib) on issue of shares to non-residents are as follows:

1. **For equity shares to be issued to any non-resident**
   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 by a merchant banker:

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

2. **For equity shares issued to notified entities**
   It has been proposed that if a company receives any consideration for the issue of equity shares from a notified entity, the price of the equity shares corresponding to such consideration, may be taken as the FMV of the equity shares for other investors as well, subject to the conditions specified below.

   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.[1]

   However, the following two conditions must be satisfied:

   a. The above benchmark applies only to the extent of aggregate consideration that is received from the notified entity; and

   b. The company has received the consideration from the notified entity within a period of 90 days of the date of issue of shares which are the subject matter of valuation.

   On similar lines, a venture capital undertaking can use the price of equity shares issued to a venture capital fund, venture capital company or specified fund as well.

   For example, if a venture capital undertaking receives a consideration of Rs 50,000 from a venture capital company for the issue of 100 shares at the rate of Rs. 500 per share, then such an undertaking can issue 100 shares at this rate to any other investor within 90 days of the receipt of consideration from a venture capital company.

3. **Selection of valuation methodology - option of the assessee**
   The choice of the method to apply is at the option of the assesee i.e. the Indian company.

4. **Time limit for valuation report**
   The draft rules provide flexibility by making valuation report issued up to 90 days prior to the date of issue of equity shares acceptable for computing FMV of such equity shares.

5. **Safe Harbour**
   The draft rules provide for an allowance of a 10% variance between the issue price and the valuation price arrived at by any of the valuation methodologies as prescribed (viz. NAV, DCF or any of the 5 (five) additional methodologies) for computing the FMV. This basically means that the variance 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 (2) above.

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[1] 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.

Conclusion

In a welcome move, the CBDT has not only prescribed additional methods for computation of the FMV of the equity shares to be issued to non-resident investors, but has also looked at plugging in practical difficulties faced by the investors by bringing in safe harbour provisions and extended time limit for using the valuation report for issue of shares.

However, notably, the draft rules only prescribe valuation methodologies for unquoted equity shares, without considering the convertible instruments such as convertible preference shares or debentures which are considered as equity instruments under the Indian exchange control regulations and subjected to pricing guidelines therein. It remains to be seen whether such instruments are covered in the final rules notified or not, which would in turn effect the way future transactions/ deals are structured and instruments used therein.

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