ALMT Legal
ADVOCATES AND SOLICITORS

Taxation of a Non-resident – Vol 1

Investments in India – Angel tax & clarifications issued

Background

What is "Angel Tax"

As per section 56(2)(viib) of the Income Tax Act, 1961 ('IT Act'), any premium received by a company (other than a public listed company), exceeding the fair market value ('FMV') of shares issued was liable to be taxed in the hands of the company. This provision was introduced vide the Finance Act 2012 to keep a check on the circulation of unaccounted money as securities premium in companies. The tax is also popularly known as '**Angel tax**' since it had maximum impact on angel investments when it was introduced.

Pre-Finance Act 2023

The ambit of this section was limited to investment by residents in Indian companies.

Several carve-outs have been provided in the section to which these provisions do not apply such as investment in specified alternate investment funds, start-ups (as duly registered with Department for Promotion of Industry and Internal Trade (**'DPIIT'**)) etc.

After Finance Act 2023 – the scope of section 56(2)(viib) is now expanded to do away with the residency of the investor. The words "from a resident" have been deleted from this section and thus the section now includes within its ambit investment by non-resident investors as well.

Conflict with valuation rules

The valuation of investments by non-resident investors are already governed under the extant exchange control regulations in India and prescribed pricing guidelines. These provide that shares issued to the non-resident investors cannot be below the FMV of the shares ('**Floor price**') but there is no upper limit prescribed. After the expansion of the scope of section 56(2)(viib), the IT Act now prescribes that the shares issued to the non-resident investors should not be above the FMV of the shares (**'Cap price'**), else differential amount received above the FMV of shares will be subject to tax in the hands of the recipient Indian company.

This effectively means that the only tax efficient option would be the exact FMV in all cases of inward investment leaving little room open for commercial negotiations in a transaction/ deal.

The manner of calculation of FMV under section 56(2)(viib) is prescribed under Rule 11UA of the Income Tax Rules ('IT Rules') whereas 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 requesting clarifications on the valuation methodology, carve-outs ups, any safe-harbor provisions etc.

Press release dated 19 May 2023

As a much awaited and welcome relief, a press release was issued by the Press Information Bureau in relation to possible amendments to valuation under the IT Rules. According to that press release the government is likely to recognise various other valuation methodologies for the purposes of section 56 and Rule 11UA. Rule 11UA currently prescribes two valuation methods with respect to valuation of shares namely, Discounted Cash Flow (DCF) and Net Asset Value (NAV) method. It is proposed to include 5 more valuation methods, available for non-resident investors, in addition to the DCF and NAV methods of valuation. The press release also states that a proposal to provide a safe harbour of 10% variation in valuation was being contemplated.

Along with the proposed changes in Rule 11UA, the press release also provides that a notification would be issued to provide for categories of excluded entities from excluded countries as well as extension of exemption to investments in start-ups.

Notifications dated 24 May 2023

Pursuant to the above press release, the Central Board of Direct Taxes ('CBDT') has on 24 May 2023, issued two notifications exempting certain persons from the provisions of Section 56(2)(viib) of the IT Act:

a. Notification 29 of 2023 bearing number S.O. 2274(E)

By way of this notification, the CBDT has stated that specified non-resident entities would be exempted from the provisions of clause (viib) of sub-section (2) of Section 56 of the IT Act. The types of specified entities include:

- Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies etc;
- Banks or Entities involved in Insurance Business;
- Any of the following entities, which is a resident of any country or specified territory as listed in the notification,
    - Entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors;
    - Endowment funds associated with a university, hospitals or charities;
    - Pension funds created or established under the law of the foreign country or specified territory;
    - Broad Based Pooled Investment Vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

The list of exempted countries included Germany, France, the United Kingdom, and the United States etc. while notably excluding countries such as Singapore, Mauritius and the Netherlands, from which India received approximately half of its FDI inflow in 2021-22.

Thus, those investors which do not fall within the specified entities or are from countries which are not specified countries as per the notification, would have to pay much more attention on how to arrive at a fair value for their future transactions into India

The detailed notification can be found here.

b. Notification 30 of 2023 bearing number S.O. 2275 (E)

Prior to the Finance Act, start-ups receiving consideration for shares from a resident were exempted from the provisions of section 56 (2)(viib) of the IT Act. By this notification, the CBDT has extended the exemption and now start-ups receiving consideration for shares, whether from a resident or a non-resident, would be exempted from the provisions this section.

Draft Rule 11UA notification dated 26 May 2023

The CBDT has invited comments from the stakeholders and general public on the draft Rule 11UA incorporating 5 new valuation methods and a safe harbour of 10%, which has been released for public consultation on 26 May 2023. The window for providing suggestions/ comments on the draft Rule 11UA is open until 5th June 2023. We will be covering the same in Volume II of this issue.

Conclusion

Significantly, other than the exemptions provided above, there have been no other exemptions granted for routine foreign investment by companies in joint ventures and M&A deals till now. Such deals will now have to be carefully structured to avoid the implications under section 56(2)(viib) of the IT Act.

DISCLAIMER