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Angel Tax – Much Ado, but the Intention Eludes

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We are seeing a lot of measures from the Indian Government favoring the facilitation of a regulatory climate conducive to young and innovative businesses. Policies viz., Make in India and Startup India are just a few of the measures that the Government has taken towards promoting entrepreneurship. By contrast, the Indian Income Tax Department (“ITD”) has been expressing reluctance in being on the same footing as the Government. One such hurdle is section 56(2)(viib) of the Income Tax Act (“IT Act”) which seeks to tax all closely held companies (referred to as companies in which public are not substantially interested under the IT Act) that issue shares at a premium, i.e., at prices higher than the fair market value of the shares, referred to as ‘angel tax’. The wide tax net of this provision also applies to start-ups that thrive on high value angel funding and venture capital investments. Albeit, the section is not attracted with investments made by a venture capital fund. In response to many representations made against the hugely dampening and negative impact of

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WHICH FOLLOWS UNION MINISTER OF COMMERCE & INDUSTRY, SURESH PRABHU'S CONSIDERATION WITH START-UPS ON THEIR ANGEL funding woes at a round table on February 4, broadens the criteria for a start-up to claim exemption from taxation and eliminates conditions associated with the kind of investments that were covered under the exemption. In our earlier post on the subject, we had observed that the ITD's steps towards granting reprieve to start-ups from taxation had been rather misplaced than demonstrative of disinclination. With due respect, we stand by this remark, as the Notification speaks volumes about the ITD having lost sight of the actual issue at hand – unaccounted income being 'invested' in large amounts in start-ups within a greater scheme of money laundering.

The Notification disbars start-ups claiming the exemption from having made certain investments and making such investments for a further seven years from an issue at premium. Non-compliance with this rule renders all exempti  granted to the start-up being revoked with retrospective effect. It appears that the intention for such restriction is to prevent over-capitalized companies or those that are otherwise flushed with funds to make capital investments outside  their core business, thus ostensibly misusing the exemption. The authors submit that this rule would adversely af  the interests of genuine start-ups if they are on the verge of exhausting their ten year tax holiday. The way the rule  drafted suggests that one could face a situation where a start-up seeking exemption from angel tax may have to refrain from investing in the specified categories of assets for as long as seventeen years from incorporation (i.e., ten years during the exemption period and seven years after the last issue at premium, if such last issue was undertaken in the tenth year). Absent a clarification, the rule will result in undue burden on start-ups. Moreover, start-ups are expected to consolidate their savings only in banks, since many prevalent modes of investment are impermissible.

Another significant change brought about by the Notification, is the elimination of preconditions relating to the minimum returned income and net worth of investors. Presumably introduced for testing the creditworthiness and legitimacy of investors, the conditions were redundant given that taxation, if at all, was in the hands of the start-up and not the investor. Under the erstwhile regulations, tax was levied at the rate of 60% when the invest

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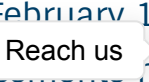
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With the aim of expanding the scope of exemption, the limit of aggregate of paid up share capital and share premium for a company to qualify as a start-up has been enhanced from INR 10 cr to INR 25 cr. Further, the period of exemption has been increased from the earlier seven years to ten years from incorporation. These changes are certain to go a long way in enabling more legitimate businesses from escaping high tax burdens under the IT Act.

A point to be noted is that in computation of the aggregate of paid up share capital and share premium, amounts in respect of issue to non-residents, venture capital companies/funds and listed companies with quoted shares meeting certain criteria, are to be excluded. This would provide start-

ups an incentive to issue shares to non-residents, even if not at a premium. Although there are sufficient int  safeguards under the law against devices that may be used to funnel in black money, this exclusion of non-residents  may open opportunities for abuse and incubate round-tripping of unaccounted income.

Additionally, there are certain operational gaps in the exemption regime as laid out in the Notification. The start-up which receives recognition from the DPIIT as an eligible start-up is required to submit a declaration that it satisfies  requirements for tax exemption with the DPIT. The DPIIT is required to forward the declaration to the Central Board of Direct Taxes (“CBDT”), however it was left unsaid whether the CBDT has the authority to reject the declaration or whether it is bound by the DPIIT’s decision in this regard. Through a notification dated March 5, 2019, the CBDT has formalized the exemption regime as intended through the Notification. Accordingly, all start-ups that register themselves and comply with the requirements of the Notification in terms of investment, paid up share capital, etc., will automatically qualify for tax exemption from the application of section 56(2)(viib) without any additional hurdles. 

The Notification is applicable to all issues of shares at a premium by those start-ups who are granted exemption by the DPIIT, except those issues in respect of which assessment orders have already been made prior to February 19, 2019. It may be unreasonable to expect the ITD to reverse completed assessments, however, ongoing assessments not final 

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startups would be eligible for the exemption.

In conclusion, the Notification seems to have achieved its intended effect – 85 new start-ups registered themselves with the DPIIT within a day of the Notification, in contrast to the hitherto recorded daily average of 10.1. However, the overall scheme of the exemption regime seems inconsistent with the Government's clear and stated intention to provide an impetus to small domestic businesses and innovation. As iterated in our earlier post, we believe that the ITD has been sidetracked by the red herring of levying hefty taxes on the start-up, the recipient of funds. The extant laws are not aimed at scrutiny of the owner and creator of the unaccounted funds, i.e., the 'angel', and testing its investment on the touchstone of unexplained investment under section 69 of the IT Act. The start-up/entity is having to bear the brunt of taxation, while the person responsible for bringing in unaccounted money into the formal economy has slipped away unscathed. While tangible relief to start-ups awaits a fundamental shift in the tax department's approach and reworking/reversing the entire exemption regime to punish the real wrong-doers, clarity over the basic practicalities discussed above is the need of the hour.



1 [Financial Express, Angel Tax Relief: Start-ups Rush to Register with DPIIT, February 22, 2019, available at https://www.financialexpress.com/industry/sme/angel-tax-relief-start-ups-rush-to-register-with-dpiit/1495071/](https://www.financialexpress.com/industry/sme/angel-tax-relief-start-ups-rush-to-register-with-dpiit/1495071/)

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