



## Angel Tax: Some Thoughts

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**Scope of this Note:** Most participants in the investing ecosystem in India are aware of the term 'Angel Tax' (even if some may be unable to recollect that, in this context, this generally refers to the provisions of Section 56(2)(viib) of the Income Tax Act, 1961 (*IT Act*) read with Rule 11UA of the Indian Income Tax Rules, 1962 (*IT Rules*) - both collectively referred to in this Note as *Angel Tax*). The Note does not cover every nuance of Angel Tax - that would require a very different and more tedious Note than this one. Angel Tax provisions have been amended with effect from 25 September 2023, and this seems to present a good reason to restate some basic aspects of Angel Tax and to make a few comments on the recent amendments. Readers will also recognise that the Angel Tax is an Indian tax law with accounting and valuation concepts built into it. They should, therefore, look to their tax advisors, accountants and valuation experts for advice in such matters.

**Excluded from this Note:** Corporate structuring difficulties faced in investment transactions caused by Angel Tax will be covered in a separate note.

**Use of Expressions:** Readers should refer to, among other things, the Angel Tax provisions, CBDT notifications, SEBI regulations, and DPIIT notifications to understand the expressions used in this Note.

**Angel Tax - What is it?** If an investor - domestic or foreign - invests in the securities (typically equity shares or convertible instruments) of an unlisted 'closely held company' at a valuation exceeding the fair market value (*FMV*) of the shares (as calculated under the Angel Tax provisions), the difference between the FMV and the

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amount paid will be taxed in the hands of the unlisted company. This tax is generally referred to as the Angel Tax. This Note is limited to Angel Tax as it applies to the *issue* of securities by the unlisted company.

**Angel Tax - exemptions:** Angel Tax does not apply to the following three categories of transactions:

- 1) The unlisted company receiving the investment is a start-up recognised by the Department for Promotion of Industry and Internal Trade (**DPIIT**) and has received a tax exemption approval from the CBDT;
- 2) The unlisted company receives the investment from a venture capital company, venture capital fund or a Category I or II SEBI registered AIF – all as defined under SEBI regulations;
- 3) The unlisted company receives the investment from entities qualifying under Notification 29 dated 24 May 2023, issued by the CBDT (**Notification 29**). The following categories of investors – both domestic and foreign - qualify under Notification 29, and their investments will be exempt from Angel Tax:
  - (a) Governments
  - (b) Central Banks
  - (c) Sovereign Funds
  - (d) International or Multilateral organisations
  - (e) Entities controlled by the Government or where ownership of the Government is 75% or more
  - (f) Regulated Banks or regulated entities involved in the Insurance business
  - (g) The following types of entities resident in the 21 countries (currently) specified in the Annexure to Notification 29:
    - (i) Category I FPIs registered with SEBI
    - (ii) Endowment funds associated with universities, hospitals or charities
    - (iii) Pension funds
    - (iv) Broad-based pooled investment funds (with 50 or more investors) are not hedge funds and do not use complex or diverse trading strategies.

**Securities:** The word 'securities' means (i) equity shares and (ii) Compulsorily Convertible Preference Shares (CCPS). This Note does not cover other instruments like OCPS, RPS and CCD.

**Valuation Date:** There is a helpful change in the valuation date of the valuation report. Previously, the requirement was to provide a valuation report as of the investment date. This was operationally very inconvenient; sometimes, investors had

to arrange an initial and updated valuation report. Now, the rules allow the investors to arrange the valuation report within 90 days prior to the issue of the shares. This is convenient.

**Calculation of FMV:** Below are the general rules for calculating the FMV of securities:

- 1) *Resident investors:* FMV of securities issued to resident investors can be determined by any of the below valuation methods:
  - (a) The NAV method
  - (b) The DCF method
  - (c) Under the paragraph Angel Tax – exemptions, we noted that if an unlisted company receives an investment from a venture capital company, venture capital fund or a Category I or II SEBI registered AIF, that investment can be made at any price because it is exempt from Angel Tax. Now, by virtue of sub-clause (c) of Rule 11UA(2) of the IT Rules, if any other resident investor wishes to invest in that unlisted company at the same valuation (whether it is below, at, or higher than the FMV) as the exempt investors mentioned above, it can do so.

However, there are 2 conditions: A) the consideration is received by the unlisted company within 90 days before or after the date of securities issued to the exempt investors; B) the number of securities and the price per security has to be the same as that issued to the exempt investors (*Note:* though the language is not clear we would think that there would be no difficulty if the resident investor acquired less securities than the exempt investors so long as it is at the same valuation. However, a more significant number of securities would not be allowed).

- (d) Under the paragraph above **Angel Tax – exemptions**, we noted that if an unlisted company receives an investment from qualifying entities resident in notified countries specified under Notification 29, that investment can be made at any price because it is exempt from Angel Tax. Now, by virtue of sub-clause (e) of Rule 11UA(2) of the IT Rules, if any other resident investor wishes to invest in that unlisted company at the same valuation (whether it is below, at, or higher than the FMV) as the exempt investors mentioned above, it can do so.

However, there are 2 conditions: A) the consideration is received by the unlisted company within 90 days before or after the date of shares issued to the exempt investors; B) the number of securities and the price per security has to be the same as that issued to the exempt investors (*Note:* though the language is not clear there may not be an issue if the resident investor acquired less number of securities than that acquired by the

exempt investors so long as it is at the same valuation). However, a greater number of securities would not be allowed).

- 2) *Foreign Investors*: FMV of securities issued to non-resident investors can be determined by any of the below valuation methods:
  - (a) The NAV method
  - (b) The DCF method
  - (c) Same as in para (c) for Resident investors above.
  - (d) Any of the following 5 valuation methods specified under sub-clause (d) of Rule 11UA(2) of the IT Rules as determined by a merchant banker:
    - (i) Comparable Company Multiple Method
    - (ii) Probability Weighted Expected Return Model
    - (iii) Option Pricing Method
    - (iv) Milestone Analysis Method
    - (v) Replacement Cost Method
  - (e) Same as in para (d) for *Resident investors* above.

**Safe Harbour:** If the issue price of the securities exceeds the FMV by 10%, the issue price will be treated as the FMV. This allows a margin of error for the parties.

**Income Tax FMV vs FEMA FMV:** This will largely affect foreign investors. According to requirements under FEMA, a foreign investor cannot acquire securities in an unlisted Indian entity at a price lower than the FMV determined in accordance with FEMA. Under Indian Income Tax, we have seen that, should investors acquire securities in an unlisted company above the FMV, the company would have to pay an Angel Tax. There is, therefore, a structuring balance to be struck between the requirements of FEMA and Income Tax so far as concerns the FMV at which securities are acquired. This will be covered in a separate note.