ANGEL TAX AND ITS IMPLICATIONS ON START-UPS

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ABSTRACT

The article will delve into great depth regarding the Angel Tax in India. A number of amendments have been added to the tax legislation concerning Angel Tax. The article begins with a quick overview of Angel Investors and their growing relevance, then continues on to the development of fresh Angel Tax regulations, and the importance of the newly implemented rules, and finally concludes with worries about amendments in Angel Tax legislation.

INTRODUCTION

Among the most pressing challenges in the Indian startup business is the tax imposition on investment in startup business shares if the price appears to be higher than the fair market value. Angel investors often make the investment, and the tax is levied on the price disparity. The angel tax has resurfaced as a deterrent to startup financing.

Angel tax was enacted by the 2012 union budget by finance minister Pranab Mukherjee to combat money laundering. The major issue that prompted the government to levy a tax on new investments beyond the fair price of shares was the exploitation of start-up privileges.

WHAT IS ANGEL TAX?

Angel tax is the tax that unlisted corporations (startups) must pay on the money they raise via the issuance of shares. Angel tax is a tax on income that is to be paid by unlisted firms on equity financing collected from financiers (usually angel investors) through the issuance of shares if the selling share price exceeds the fair market value of the shares. The difference between the price of a share and the fair market value is considered revenue & taxable appropriately. The tax was levied on angel investments, which are meant to be made in "start-ups", therefore the name given is "angel tax." Startups that receive such funding must pay the amount of tax.

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HISTORY OF THE TERM "ANGEL INVESTORS"

The word "angel" originated in the Broadway theatre, when affluent benefactors contributed funds to promote theatrical shows. The phrase "Angel Investor" was coined by William Wetzel, founder of the "Centre for Venture Research at the University of New Hampshire". Wetzel did research on how businessmen raise money.

THE REASON FOR INTRODUCING THE ANGEL TAX

This was implemented to combat black money through the use of round-tripping and money laundering. Round tripping is the unlawful practice of repeatedly purchasing and selling shares of the same firm numerous times in order to fool observers into believing that the security is in more demand than it was originally.

According to section 56(2)(vii)(b) of the Income Tax Act of 1961, any premium received by a corporation (other than a publicly traded firm) from a resident that exceeds the Fair Market Value (FMV) of the share issued is taxable in the hands of such company.

This clause, known colloquially as the 'Angel tax,' was introduced by the Finance Act of 2012 to limit the movement of unexplained money as a share premium. Non-resident investments may have been excluded from angel tax regulations due to additional compliances under exchange control, which necessitate registration in a foreign jurisdiction. While the provisions of this section apply to the issuance of all types of shares, the issuance of instruments such as convertible debentures is exempt from the provisions.

The resident investors expected that some sought of relaxation would be provided to them by the government but on the contrary, rather than providing relaxation to resident investors by eliminating the Angel tax, the government has tried to achieve equivalence in taxes by extending the rules to non-resident investors. The objective of the Finance Bill of 2023 presently wants to eliminate the residency requirement from the clause, making it applicable even when the shares are offered to non-resident investors. This modification would apply to shares issued and consideration received on or after April 1, 2023.

According to India's foreign exchange pricing standards, shares issued to non-resident investors cannot be priced below the FMV of the shares, which serves as a pricing floor. The angel tax currently intends to tax any sum received as income in excess of FMV in the hands of the companies. As a result, the only tax-efficient alternative for a firm would be to obtain investment at the precise FMV of the shares, which could potentially impact investment pricing talks.

The newly amended provision may dissuade potential foreign investors from making investments in India and also can make the Start-Ups scrutinise restructuring their holding abroad to elude pressure from perturbed investors.

But the rationale behind introducing such a provision is that the government wants to embolden foreign investors to invest in the Indian Companies

How much money is eligible for Angel Tax?

The excess consideration received is taxable under the head income from other sources under section(56)(2)(vii)(b) of the Income Tax Act 1961 and is chargeable at the rate of 30% +3% cess. The Total taxable rate is 30.9%.

New amendments to the angel tax Regulations:

- Previously, Corporations with revenue of not more than Rs 25 crores were exempted from angel tax. Under new guidelines, the exemption level has been increased to corporations with an annual turnover of not more than Rs 100 crores & who are not more than ten years old.

- Investments undertaken by publicly traded corporations having a net worth of not less than 100 crores or a total turnover of a minimum of 250 crores would be exempted from tax; similarly, investments done by non-resident Indians will also be exempt from tax.

- A qualifying startup refers to one which has been registered with the government, has been incorporated for a minimum of ten years, and has a turnover of less than 100 crores during that time.

- In addition, the minister of finance stated that an e-verification method would be implemented to address the problem of verifying the identity of the investor and the origin of his funding. As a result, the funding received by startups will not be subject to Income Tax Department inspection.

- It was also declared that startups are no longer obliged to provide the fair market value of their shares given to particular investors, such as Category-I Alternative Investment Funds (AIF).

What are the exemptions to Angel Tax?

This section would exempt recognised start-ups (who have submitted a declaration in Form 2 with the Department for Promotion of Industry and Internal Trade (DPIIT) from offering shares to resident and non-resident investors. Furthermore, as is currently the case, investment in Indian companies through specified funds such as Alternative Investment Funds (AIFs) would fall outside the scope of this section.

- Non-resident entities registered with the comparable regulatory authorities of the Reserve Bank of India (RBI)/ Securities Exchange Board of India (SEBI) in their respective countries, such as entities from Financial Action Task Force whitelist nations;

- Entities/funds that meet the criteria for Category I Foreign Portfolio Investors under the SEBI FPI Regulations 2019, even if they are not registered with SEBI; and

- Direct/indirect investment by sovereign wealth funds and pension funds meeting the definition in section 10(23FE), even if not registered as a "specified person" under section 10(23FE).

- A venture capital undertaking from a venture capital company or a venture capital fund or a specific fund.

- By a company from class a class or classes of persons as may be notified by the Central Government on this behalf.

- The aggregate amount of the paid share capital and share Premium of the startup after the issue or proposed issue of a share, if any, does not exceed,₹ twenty-five crore (25 crores).

Furthermore, where shares are issued at a price higher than the valuation report by category - I merchant banker, a safe harbour mechanism/tolerance limit of up to 25% may be provided.

Any valuation disputes that exceed the 25% tolerance level should be sent to an approval panel (similar to GAAR) for a fair examination of the matter.

THE IMPORTANCE OF THE LATEST REGULATIONS

The guidelines will undoubtedly make things simpler for start-ups in dire need of funding to fuel their expansion and other company needs. The modifications will motivate affluent people to support start-ups that obtain financing at a premium due to their unique business strategy, even if the value is not supported by the actual assets they own. Additionally, because the new regulations are retroactive, many fledgling corporations that got notices from the Department of Income Tax in the past will be eased by the current rule change.

ISSUES REGARDING THE ANGEL TAX

- To take advantage of the most recent exemptions, corporations must be registered with the government as "startups".
- To be designated as a "startup", a corporation must demonstrate that it has not invested in automobiles costing in excess of ten lakhs, land not related to the business or jewels.
- These constraints, which are most likely meant to avert the laundering of money, can cause significant administrative holdups in addition to rental-seeking.

- Furthermore, the updated angel tax regulations, while less harsh than before, may result in the same old problem of capricious tax requests for corporations that do not belong within the designated startup class.
- Taxes are determined depending on the sum by which the "selling price" of the corporation's unlisted shares exceeds its "fair market value".
- The "market value of shares" that are not openly traded on the market cannot be determined. As a result, tax officials with dubious motives might continue to hound entrepreneurs with unjustified tax requests. The trust of investors may suffer indefinitely until the government addresses the capricious character of the angel tax.

Is it possible to get rid of the Angel Tax?

The angel tax couldn't be repealed since money laundering is a serious issue. There is a nexus of Two Hundred shell corporations that have been in control since 2012, thus it is not possible to eliminate them.

CONCLUSION

Considering the reality that the Angel Tax was implemented with noble intentions, it has resulted in several negative consequences. Angel Tax is strongly opposed by both startups and investors. As a consequence, the progress of start-ups has slowed dramatically since they have extra funds. Investors, on the contrary, are hesitant to make investments in tiny corporations. This has completely upset the equilibrium, making startup survivability much more difficult. Startups face a lengthy and risky journey.