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Angel Tax [UPSC Notes for GS III]

Angel Tax

Context: Angel tax rules for start-ups changed

Who are Angel Investors?

Angel investors are high net worth individuals who invest their personal income in business start-ups or small and medium scale companies.

Why they are gaining importance?

Angel investors finance small startups. They provide funds at a stage where such startups find it difficult to obtain funds from traditional sources of finance such as banks, financial institutions, etc. In this way, they encourage entrepreneurship in the country. Further, such investors provide mentoring to entrepreneurs as well as access to their own business networks. Thus, they bring both experience and capital to new ventures.

What is Angel Tax and the issue related to them?

- Angel Tax, formally known as Section 56 (2) (viib) of the Income Tax Act, taxes funds raised by startups if they exceed the fair market value of the company. It was introduced in 2012 by the UPA government in order to detect money laundering practices and catch bogus startups.
- In the past few years, many startups have raised concerns over angel tax calling it an extremely unfriendly and unfair tax as it is not possible to calculate the fair market value of a startup. They have also alleged that to calculate the fair market value, the Assessing Officer (AO) chooses the cash discounted flow method, which is not very startup-friendly but suits the tax officers.
- Last December, over 2,000 startups in the country received notices to clear the angel tax and some of them were also notified to pay an expensive penalty for not paying the dreaded tax on time. Also the dept. Asks for documents which usually are not required.

What are the new rules?

- According to the new rules, investments up to ₹25 crore in companies that are less than 10 years old and with a total turnover of less than ₹100 crore will be exempted from the new angel tax instead of the existing cap of ₹ 25 crore.
- Further, investments made by listed companies with a net worth of at least ₹100 crore or a total turnover of at least ₹250 crore will be fully exempt from the tax; so will investments made by non-resident Indians.
- An eligible start-up would be one that is registered with the government, has been incorporated for less than 10 years, and has a turnover that has not exceeded ₹100 crore over that period.
- Also, the Finance Minister announced that a mechanism of e-verification will be put in place to resolve the issue of establishing the identity of the investor and source of his funds. With this, funds raised by startups will not require any kind of scrutiny from the Income Tax Department.
- Also announced that startups will not be required to present their fair market value of their shares issued to certain investors including Category-I Alternative Investment Funds (AIF).

Significance of new rules

- The rules will definitely make life easier for start-ups, which are in desperate need for capital to fund their growth and other business requirements.
- The changes will encourage wealthy individuals to invest in startups that receive capital at a premium on account of their innovative business model although the valuation is not justified by the physical assets

they hold.

- Further, since the new rules are applicable retrospectively, many young companies which received notices from the Income Tax Department in the past will be relieved by the latest tweak in the rules.

Concerns

- Companies need to be registered with the government as start-ups to make use of the latest exemption.
- To be classified as a startup, a company has to prove certain conditions such as that it hasn't invested in vehicles worth more than ₹10 lakh, in land unrelated to the business, or in jewellery.
- These conditions, which are probably intended to prevent money-laundering, can lead to a lot of bureaucratic delays as well as rent-seeking.
- In addition, the new rules for angel tax, although less severe than earlier, can cause the same old issue of arbitrary demands for tax for companies that don't fall under the defined start-ups category.
- Taxes due are calculated based on what amount the sale price of a company's unlisted shares is greater than its fair market value.
- It is not possible to know the market value of shares that aren't openly traded in the market. So tax authorities with questionable intentions can still find reasons to harass startups with unreasonable demands for tax. The damage to investor confidence may stay unless the government does something about the arbitrary nature of this angel tax.

The changes, when seen in totality, are welcome, for startup companies. The changes will also assuage the government's concerns to a small extent with respect to shell companies evading taxes under this mechanism, while permitting exemptions for startup organisations.