Angel Tax [UPSC Notes for GS III]

This article will describe in detail the topic of Angel Tax in India. There were a few changes made to the tax laws related to Angel Tax. This article starts by sharing brief details on Angel Investors, their rising importance, and then moves on to the formulation of new rules related to Angel Tax, the significance of those new rules and finally culminating with the concerns associated with changes in the Angel Tax Laws.

Aspirants would find this article very helpful while preparing for the IAS Exam.

These UPSC Notes on angel tax and angel investors in India as well as related concerns are aligned with the UPSC Syllabus and aspirants should prepare this topic from the perspective of General Studies Paper III.

Angel Tax

In the recently launched Budget 2023-24, **the government has proposed to extend the provisions of 'angel tax' to transactions involving foreign investors.** Angel taxes are taxes funds raised by startups if they exceed the fair market value of the company.

Angel Tax New Proposal

- It is related to the premium received. If an Indian unlisted company receives an excess premium on the sale of shares to a foreign investor, the premium is considered "income from other sources". And it will be subject to tax.
- Before this proposal in budget 2023-24, angel tax was imposed only on investments made by a resident investor.

Proposed change:

- The amendment is required in the Finance Bill, 2023. It has proposed to amend Section 56(2) VII B of the Income Tax Act.
- It will include foreign investors in the ambit of tax. When a start-up raises funding from a foreign investor, it will also be counted as income and be taxable after the amendment.
- But, exceptions are also made. It mentions that foreign investors will not need to pay any angel tax while investing in a government-recognised (Department for Promotion of Industry and Internal Trade (DPIIT) registered) startup in India.

Possible impacts:

- It can impact the funding of startups, as the proposal has come in the declining funding trend in startups. India's startups dropped by 33 per cent to $24 billion in 2022 as compared to the previous year.
- Indian startups get a major source of funds from foreign investors.
- The source and amount of funding also impact their valuation.
- It can generate fear among the startups as the imposition of angel tax impacts the fair market valuation of the company. The tax department calculates market value based on the net assets of the company. But the estimated growth prospects and future projections based on these growth prospects determine the fair market valuation of the startup.
- The proposal can damage confidence in the startup ecosystem.
- The proposal can also impact the FDI inflow that we get from these foreign investments.
- The investors may not want to deal with additional tax liability in investment in a startup.

Though, to relieve such anticipation, the DPIIT secretary has mentioned that 'Angel Tax' provisions in Finance Bill will not impact startups. As exceptions are also there for investing in a government-recognised (Department for Promotion of Industry and Internal Trade (DPIIT) registered) startup in India. And it is an easy process to get recognition from the department, as said by the DPIIT secretary.

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?

1. **Angel Tax, formally known as Section 56 (2) (vii b) 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.**
2. 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.
3. 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?

1. As per earlier rules, the exemption from angel tax was for companies with turnover up to Rs 25 crores, but as per new rules, the exemption limit has been extended to companies with turnover less than Rs 100 crores and those companies should be less than 10 years old.
2. 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.
3. 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.
4. 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.
5. Also announced that startups will not be required to present the fair market value of their shares issued to certain investors including Category-I Alternative Investment Funds (AIF).

Significance of New Rules

1. 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.
2. 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.
3. 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

1. Companies need to be registered with the government as start-ups to make use of the latest exemption.
2. 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.
3. These conditions, which are probably intended to prevent money-laundering, can lead to a lot of bureaucratic delays as well as rent-seeking.
4. 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.
5. Taxes due are calculated based on what amount the sale price of a company's unlisted shares is greater than its fair market value.
6. 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.

Is Scrapping Angel Tax possible?

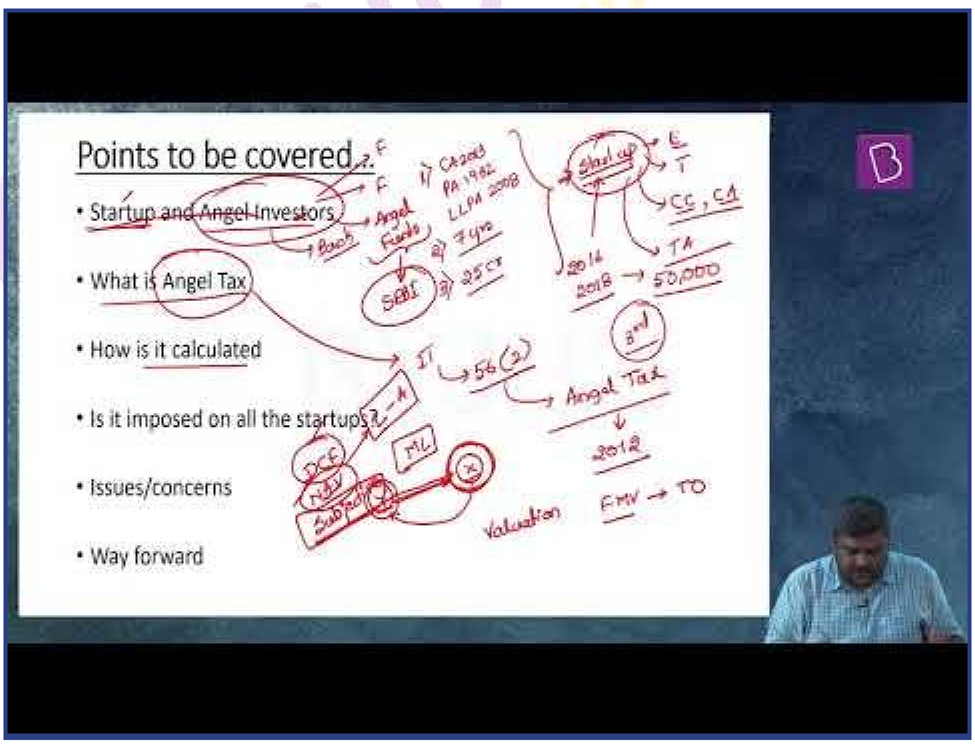
The angel tax could not be scrapped as money laundering is a major problem. There is a network of 200 shell companies and they have been under control since 2012, so it cannot be scrapped.

However, concessions are under consideration with the size of the start-up, the duration of its operation, and the income of the angel investor.

Steps Taken by Indian Government Against Tax terrorism

In order to reduce the long pending grievances of taxpayers and to minimize litigations pertaining to tax matters, the Government of India in July 2018, decided to increase the threshold monetary limits for filing Departmental Appeals at various levels.

- Goods and Services Tax has been introduced.
- Insolvency and Bankruptcy Code has been implemented.
- "Kardaata e-Sahyog Abhiyaan" has been launched by CBDT etc.



Consider the following statements

1. Angel investors are high net worth individuals who invest their personal income in business start-ups or small and medium scale companies.
2. Angel Tax, formally known as Section 56 (2) (viib) of the Income Tax Act, was introduced in 2010.
3. Exemption from angel tax was for companies with turnover up to Rs 500 crores as per old rules.
4. Exemption from angel tax for companies has been increased to 200 crores as per new rules.

Which of the following Statements are true?

A) All the statements are true

B) None of the statements are true

C) Only 1 is true

D) Only 3 and 4 are true.

Answer: C