Can Angel Tax Become Devil's Tax For Foreign Investors? - Need For A Relook

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All said and done on the much anticipated last full-fledged Budget of the current Indian Government, the Honorable Finance Minister has managed to strike a chord to achieve the twin objectives of fiscal consolidation and continued focus on Capex.

In the context for foreign investor participation, the pathbreaking numbers rolled out by the Economic Survey 2022-23 clearly reflects about the confidence of offshore investors and position of the India's economy amongst its peers in the midst of global uncertainty due quite a few macro factors.

India's gross FDI has increased from an average of 2.2 % of GDP during the fiscal period 2005 - 2014 to 2.6 % during the fiscal period 2015 -2022. The highest-ever annual gross FDI inflow of USD 84,800 mn was recorded in Fiscal Year 2022.

However, one of the Budget proposals which is inviting sleepless nights for foreign investors is "Angel Tax" may put the brakes on the much needed foreign inflows in India. The Budget proposals seeks to widen the applicability of such tax to investment received in the form of capital from foreign investors which is currently restricted to domestic investors.

Earlier, the so called 'Angel investors' could structure a deal by investing in the shares of a closely held company at a value over and above the Fair Market Value ('FMV') of such shares i.e., at a high premium. Therefore, the deeming provisions under section 56(2)(viib) of the Income-tax Act, 1961 ('IT Act'), popularly known as the "Angel Tax", was introduced for the first time in the year 2012. The basic premise for introduction of the said provision was to restrict roundtripping of cash.

However, this also led certain genuine transactions to get caught under the tax scanner. The start-ups, which received initial capital infusions to meet their liquidity had to defend the pricings, despite of the same being arrived basis the existing exchange control regulations. The pricing guidelines under the Foreign Exchange Management (Non-Debt Instrument) Rules, 2019 require that foreign investments must be made at or above FMV (as determined by a merchant banker, usually following the Discounted Cash Flow ('DCF') method).

Even the Rule 11UA of the Income-tax Rules, 1962 provides for valuing the unquoted shares of a company either on the basis of the net asset value per share, or by way of the DCF method, determined by a merchant banker. As a corollary, with the proposed changes of applicability of the aforesaid provisions to all investors, the non-resident investors will have no choice but to finalise the deals exactly at FMV.

Also, in the past, the tax authorities have gone beyond the statutory powers and challenged the pricing at which deals are concluded, specifically for angel funds and start-ups. The deals are generally in compliance with the DCF method prescribed under the aforesaid Income tax Rules and the relevant pricing norms under exchange control regulations.

From a taxpayer's perspective, one may even challenge the tax authorities for enactment of such provisions on the basic premise of constitutional validity. The tax authorities cannot exercise discretionary powers to determine the value at which business deals should be concluded by the taxpayers. Whether they can question the valuations of equity shares which are done in accordance with the pricing norms applicable to non-residents, arrived after commercial negotiations, and basis other factors such as anti-dilution rights, priority on liquidation, etc. is worth deliberating.

In India, typically most startup companies receive overseas investments from large established institutions or HNIs having confidence in their business model that it will grow in multiples and give them expected returns. Hence, they rely on valuations which are generally higher than current price of such start-up investee company. These deeming provisions to tax capital infusion will have a severe impact on the private equity deals having offshore investments.

Another aspect worth highlighting is that the Angel Tax provisions apply only if the investment is via equity shares issued by a company. Hence it will provide the gateway for investors to explore other investment structures using LLP or another non-corporate entity issuing debt instruments such as Compulsorily Convertible Debentures which will make the equity market less lucrative.

In order to bury the hatchet, the Government may consider bringing in a suitable clarificatory amendment while tabling the Finance Bill, 2023 before the Parliament for approval.

There is a need to harmonise the valuation rules and pricing mechanism for calculating the FMV of equity shares of unlisted companies under the tax laws and the exchange control regulations.

Since the deals involve overseas investor community, instead of prescribing a particular valuation method, the Government may consider accepting the valuation done on the basis of internationally accepted valuation methodologies. This will remove subjectivity and bring in fairness to all the early stage companies doing fund raising exercise by exhibiting potential growth which may not be currently backed by traditional valuation methodologies.

India is witnessing a dramatic shift of businesses houses in the shape of start-ups which were once offshore. Its apt time for the Government to keep the momentum going by allowing ease of doing business and clarity on tax perspective to non-residents planning for inbound investments.

This will amplify India to be ranked as one of the fastest growing economies in the world and achieve the milestone of becoming a USD 5,000,000 mn economy by 2025 and USD 7,000,000 mn by 2030.

Hope the Government will address the lacunae and make the existing framework for both inbound and outbound investments more robust.

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