

INTERNATIONAL JOURNAL OF LEGAL SCIENCE AND INNOVATION

[ISSN 2581-9453]

Volume 2 | Issue 1

2020

© 2020 *International Journal of Legal Science and Innovation*

Follow this and additional works at: <https://www.ijlsi.com/>

Under the aegis of VidhiAagaz – Inking Your Brain (<https://www.vidhiaagaz.com>)

This Article is brought to you for “free” and “open access” by the International Journal of Legal Science and Innovation at VidhiAagaz. It has been accepted for inclusion in International Journal of Legal Science and Innovation after due review.

In case of **any suggestion or complaint**, please contact Gyan@vidhiaagaz.com.

To submit your Manuscript for Publication at **International Journal of Legal Science and Innovation**, kindly email your Manuscript at editor.ijlsi@gmail.com.

Angeltax- The Making and Unmaking of Startup India

SMRITI SHASHIKANT NAIK¹

ABSTRACT

With the birth of Start-up India, we have witnessed an enormous pour of new companies coming up from different parts of the country.

Off late, Indian companies have seen huge investments. The investor societies across the world have come up with huge investments in the Indian market because of the sheer size of the market that is available in the second most populous country in the world.

However, over the past few months the economy has literally come to a standstill due to the ongoing Pandemic that has engulfed the entire world. All the businesses have become stagnant. But the recent announcement by PM Narendra Modi about “ATMANIRBHAR BHARAT” has come in as a harbinger of good hope charting the course for all the start-ups in the country.

With the institution of start-up India and ATMANIRBHAR BHARAT, the plan has indeed paved way for high net worth individuals, foreign funds, angel investors, venture capitalists, almost every possible individual or a company that is capable of investing has played a role in investing in various Indian Start-ups.

Looking at the present situation around the world and the significantly detrimental effect on the economy, Start-ups seems to be the only major source of revenue and employment. Government is ensuring that while it successfully facilitates the entrepreneurial dream of individuals by its flagship “ ATMANIRBHAR BHARAT” programme and a plethora of other schemes like ‘Start-up India’ it is also making sure that these opportunities are not taken for granted and entrepreneurs make full use of these schemes by being well within their rights.

While we have a great opportunity of Start-up India knocking at our doors. We need to look into the entire revolution of Star-ups, primarily talking about the Angel tax.

On one hand the scheme of Start-up will massively boost the economy, on the other hand we need to critically analyse the hindrance that entrepreneurs faced while trying to lay the foundation for their business. Angel Tax is one such speed breaker. Angel Tax was introduced by then Finance Minister Mr Pranab Mukherjee to tackle the malaise of generation and circulation of black money and its illegitimate transfer outside India in

¹ Author is a student at V. M Salgaocar College of Law, India.

2012.

The imposition of angel tax hinges on the fair market valuation of the company and this has been a bone of contention between Start-ups and the income tax department.

This this paper critically analyses the drawbacks of the Angel Tax and how it posed as a roadblock to all the potential entrepreneurs over the past few years until August 2019.

Keywords: Angel Tax, Angel Investors, Fair Market Value, General Anti-avoidance Rule (GAAR), Securities and Exchange Board of India (SEBI), Department for Promotion of Industry and Internal Trade (“DPIIT”).

I. INTRODUCTION

(A) ANALYSIS OF ANGEL TAX WITH REPECT TO MAKING AND UNMAKING OF START-UP INDIA

The Indian Start-up eco-system is able to thrive when new ideas are nurtured at the very initial stage by providing right funding and investment. In India, start-ups are taking firm roots and their continued growth is what will define the future of the Indian Market.

More and more angel investment should happen from domestic individual for the ecosystem to grow in real terms. Angel funding is the backbone of any rising start-up ecosystem. Entrepreneurs thrive on angel investments at the right time for want of financial backing.

However, the introduction of angel tax has remained the nightmare for the entire Indian Start-up community and has for long been dreaded by them.

‘Angel Tax’ refers to section 56 (2) (viib) of the Indian Income Tax Act, 1961, wherein the Income Tax Authorities are demanding additional taxes from ‘Start-up Companies’ who have received funding from Indian Resident ‘Angel Investors’ at a valuation higher than what can be perceived for an early stage start-up venture².

The law clearly says that in case of equity or preferential investments in a Company, anything over and above the Fair Market Value (FMV) of the Shares shall be taxable as ‘Income From other sources’ for the Company.

Also, the FMV shall be the higher of the valuation as per prescribed rule 11UA or ‘to the satisfaction of the Assessing Officer (AO)’.

Rule 11UA talks about the computation of book value of the shares as computed by the defined formula or as per Discounted Cash Flows (DCF), certified by a CA or merchant

² Section 56(2)(viib) of the Income-Tax Act

banker³.

The problem with an ‘angel tax’ is that Start-ups generally have no profits, often no revenues and practically no assets. Angel investors value them based on the potential value of the idea, the probable market size, the quality of the founders/team and their passion. More often than not do two investors agree on a valuation. In this world, any prescriptive valuation norm is pointless. AOs, not well-equipped to value companies with negligible/negative book, inescapably tax their investment as income⁴.

The share issued to an investor was supposed valued to decide whether the price is in excess of fair value. The industry therefore wanted to opt for the method of discounted cash flow (DCF) to calculate angel over the net asset value (NAV) even though it is not the perfect method to analyse the actual value of a Start-up⁵.

The valuation of a Start-up is usually based on a commercial negotiation between the company and the investor and is a function of the company’s projected earnings at that point in time.⁶

(B) The Added Dread of Section 68

In addition to the challenges with 56(2)(viib), Section 68 of the Income Tax Act, 1961 adds another edge to these issues. Section 68 states that any sum credited to the books of accounts of an assessee can be charged to tax if:

- The assessee is unable to explain the source of the credit;

OR

- The explanation is not **to the satisfaction of the Assessing Officer**

Several Start-ups, who have faced the wrath of section 56(2)(viib), also had to struggle with section 68, which again **allows for tremendous discretionary powers in the hands of the Assessing Officer compounded by the discretionary powers already afforded by section**

³Rule 11UA Income-tax Act, 1961

⁴ Saurabh Srivastava, Scrap Section 56 of the I-T Act to not throttle India’s Start-up ecosystem ET TECH (Jan 19, 2019) 06.10 AM
[//economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst](https://economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

⁵ Saurabh Srivastava, Scrap Section 56 of the I-T Act to not throttle India’s Start-up ecosystem ET TECH (Jan 19, 2019) 06.10 AM
[//economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst](https://economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

⁶ ET Bureau: What is Angel tax? <https://economictimes.indiatimes.com/news/economy/finance/et-in-the-classroom-what-is-angel-tax/articleshow/67202362.cms?from=mdr>

56(2)(viib)⁷.

Many entrepreneur and experts were of the opinion that Section 56 needed to be abolished completely as section 68 and General Anti-Avoidance Rules (GAAR) are fully adequate to address the requisite concerns⁸.

(C) GAAR

GAAR was introduced in on 2017 General Anti-avoidance Rule (GAAR) bestows power to the Revenue Authority in a country to turn down any tax benefit of transactions or arrangements which do not have any commercial substance and the only motive of such a transaction is achieving the tax benefit. The need for a GAAR is usually justified by a concern that the basis of the integrity of the tax system needs to be strengthened⁹.

Angel Tax Exemption

Poring deeply into the perils of the Start-up community, the Government had exempted investments made by the domestic investors in companies approved by an inter-ministerial panel from Angel Tax from April 2018. However, in order to qualify for angel tax exemption, the Start-up should meet certain criteria that are:

- The paid-up capital and share premium of the Start-up should not exceed Rs. 10 crore after issuing shares.
- The Start-up should procure the fair market value certified by a merchant banker.
- The investor should have a minimum net worth of Rs. 2 crores and the average income in the last 3 financial years should not be less than Rs. 50 lakh¹⁰.
- The Start-up should have received approval from 8 member inter-ministerial board for angel tax exemption.

In June, 2013- the Securities and Exchange Board of India (“SEBI”) under the SEBI AIF (Alternative Investment Funds) Regulations, 2012 took cognizance of angel Investments, as funds raised by unlisted entities from angel investors. It ensured that SEBI-registered angel

⁷Siddarth Mohan Pai, Angel Tax in India — Demystified and Explained

<https://medium.com/3one4capital/angel-tax-in-Indias-demystified-and-explained-9c9fd6fbad7>

⁸ ET TECH *Industry roots for Angel Tax abolition, AI-enabled solutions*

[//economictimes.indiatimes.com/articleshow/69463785.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst](https://economictimes.indiatimes.com/articleshow/69463785.cms?from=mdr&utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

⁹ General Anti-Avoidance Rules (GAAR) India and International Experience March 2017

<https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-gaar-india-and-international-experience-noexp.pdf>

¹⁰ REGD. NO. D. L.-33004/99, MINISTRY OF COMMERCE AND INDUSTRY (Department of Industrial Policy and Promotion) NOTIFICATION New Delhi, the 11th April, 2018 <https://www.Start-upIndia.gov.in/content/dam/invest-India/Industries/Start-up%20Notification11April2018.pdf>

funds in approved investee companies will be exempted from the from paying Tax even if its price is beyond the fair market value. Later on in June of 2013, SEBI capped the investments to amounts between Rs. 50 lakhs and Rs. 5 crores and set out that the only the companies incorporated in India with a turnover of not less than Rs 10 Crores and more that Rs 25 Crores could have investment from an Angel Investor.¹¹

Between 2013 to 2018 many committees looked into the consequences of angel tax and made suggestions which eventually led to the Department of Industrial Policy and Promotion (“DIPP”) announced exemption on angel tax in 2018. Angel funds can benefit tax relief over issues of shares in excess of the fair market value¹² if the aggregate amount of paid-up share capital and the share capital of a start-up post issue does not exceed Rs. 10 crores¹³ [with a proposal to revise this to Rs. 25 crores]. Further, a start-up can avail 100 per cent tax exemption through the form notified by DIPP for any three (3) consecutive years out of the initial seven (7) years.

Thanks to the DIPP notification, Start-ups will receive a valuation report from a merchant banker, for dual purpose that is for the exemption and under the ITA. This will substantially increase the costs to often struggling Start-ups.¹⁴

Though this official notification tried to ease the stringent law, it was just not enough to provide with a conducive and amicable solution for the entrepreneurs.

The tax laws were seriously flawed, because illegal payments cannot be prevented using tax laws. The corrupt will find other ways to pay. The anti-corruption laws that needs yo be more stringent, not the payment mechanism. Section 56 is a flawed legislation as it seeks to “Hastily tax” — and, thereby, legitimise —an illegal transaction rather than prosecute the wrongdoers¹⁵.

II. EMPERICAL DATA

Around 2000 or 72% of the Start-ups that had received angel funding since their foundation

¹¹ SEBI (Securities and Exchange Board of India) **Jun 25, 2013** https://www.sebi.gov.in/media/press-releases/jun-2013/sebi-board-meeting_24942.html

¹² MINISTRY OF COMMERCE & INDUSTRY DEPARTMENT OF INDUSTRIAL POLICY & PROMOTION <https://dipp.gov.in/sites/default/files/lu2646.pdf>

¹³ MINISTRY OF COMMERCE & INDUSTRY DEPARTMENT OF INDUSTRIAL POLICY & PROMOTION https://dipp.gov.in/sites/default/files/Start-up_Notification11April2018_0.pdf

¹⁴ NIVEDITA NIVARGI AND BHADRA MENON *ANGEL TAX EXEMPTION: IS THERE A REAL BENEFIT?* INDIAN BUSINESS LAW JOURNAL

¹⁵ Saurabh Srivastava, *Scrap Section 56 of the I-T Act to not throttle India’s Start-up ecosystem* ET TECH (Jan 19, 2019) 06.10 AM [//economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst](https://economictimes.indiatimes.com/articleshow/67594258.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst)

(before or after 2011) were served with one or more angel tax notices from the income tax department¹⁶.

From 2,883 Start-up responses, 45% Start-ups had received one or two such notices while 28% Start-ups said to have got three or more notices questioning the angel investment raised.

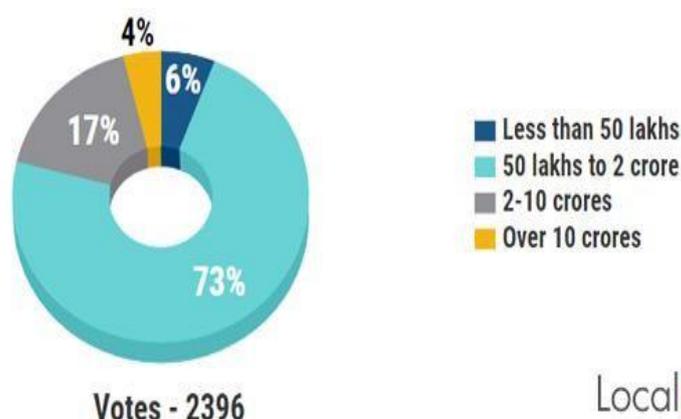
73% Start-ups that received angel tax notices had raised funding between Rs 50 lakh to Rs 2 crores¹⁷.

The notices were sent to Start-ups under section 56(2)(viib) (angel tax) or section 68.

Section 68 pertains to taxing the funding raised by Start-up if it is unable to explain the source of capital raised or the explanation itself is not satisfactory as the Assessing Officer.

70% Start-ups had got notices under angel tax while only 6% got it under section 68. 24% respondents said that they were sent notices under both sections¹⁸.

As a recipient of angel tax notice(s), what was the total amount of fundraising being questioned?



73% of startups that received angel tax notice(s) raised capital between 50 lakhs to 2 crores

All contents in the above graphic is a copyright of LocalCircles and if published or broadcasted, must carry the LocalCircles logo along with it.

¹⁶ Local Circle <https://www.localcircles.com/a/press/page/Start-ups-received-angel-tax-notice#.XaLUYEYzbIU>

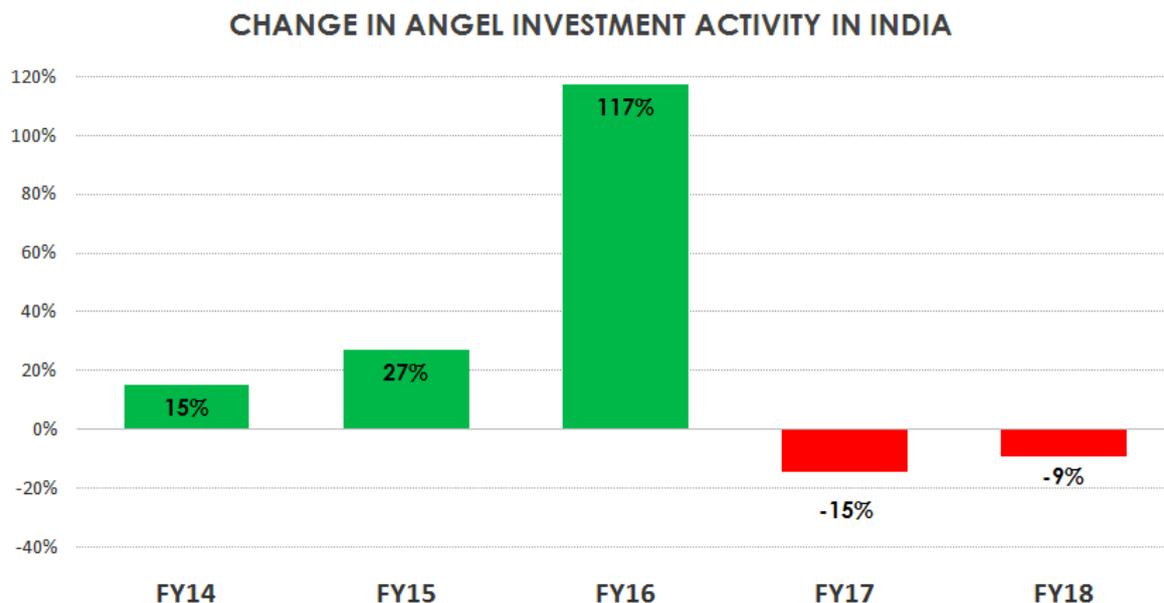
¹⁷ Suprita Anupam, *Indian Start-up Ecosystem Badly Hit By Angel Tax* <https://inc42.com/features/Indian-Start-up-ecosystem-badly-hit-by-angel-tax-suggest-recent-reports-survey/>

¹⁸IDIB note 15 at 6

III. CHANGE IN THE NUMBER OF ANGEL INVESTORS

There has been a tremendous downfall in financial support shown by the angel investors in the over the past several years as per the data that has been shown.

In the subsequent years there is a huge change in angel investment activity in India just goes to show how hesitant and cautious the Angel investors are before making an investment in the start-up.



Based on change in investment activity of Super Angels and Angel Networks. Investments by other angels while increasing by 101% in FY17 fell 44% in FY18.

VENTUREINTELLIGENCE.COM

DPIIT 2019 notification

Governments globally are recognising the usefulness of encouraging and inviting angel investors to boost their start-up economies. To this end, many global start-up hubs offer tax cuts and incentives to attract angel investors¹⁹.

Hence, concerns continued to be expressed by the start-up businesses regarding applicability of section 56(2)(viib) (including misuse of provisions by tax authorities while making assessments on start-ups), and various representations were made before the Government of India²⁰.

To assuage these concerns, the Department for Promotion of Industry and Internal Trade

¹⁹ Rajesh Sivaswamy *Taxing The Angels: Stifling The Indian Start-up Eco-system*
<https://ksandk.com/tax/3400/>

²⁰ Department for Promotion of Industry and Internal Trade (DPIIT) under the Ministry of Commerce and Industry, vide notification1 dated 19 February 2019

("DPIIT") has issued a Notification dated 19-02-2019 ("Notification") in supersession of earlier notifications dated 11-04-2018 as modified by another notification dated 16-01-2019. At its core, there are three key aspects of this Notification: definition of start-ups (as per DPIIT); eligibility for claiming deduction under Section 80-IAC of the IT Act; and exemption under Section 56(2)(viib) of the IT Act. A few important aspects pertaining to these are set out below:

Definition of start-up expanded The Notification provides that an entity shall be considered as a start-up²¹:

1. Up to a period of 10 years from the date of incorporation/registration as a private limited company or a limited liability partnership. (earlier, this period was 7 years)
2. If the turnover of such an entity for any of the financial years since incorporation/registration has not exceeded INR 100 crores (earlier threshold was INR 25 crores in line with Section 80-IAC of the IT Act)
3. Such an entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.

An entity will no longer be a start-up if it has completed 10 years from the date of its incorporation/registration or its turnover for any previous year more than INR 100 crores.

Section 80-IAC of the IT Act²²

There are certain criteria that needs to be fulfilled in order to 80-IAC of the IT Act for an entity:

1. It should contribute to the innovation, development, growth or improvement of products or processes or services, which will generate large employment base for people.
2. The Incorporation of the entity must take place on or after 01-04-2016 but before 01-04-2021
3. The maximum turnover must be limited to INR 25 crores in the year in which the deduction is claimed on fulfilment of the above conditions, an entity may obtain certification by filing an application in Form 1 with the Board.

It's on the Board's discretion to either grant the certificate or reject the application.

²¹ IDIB note 18 at 9

²² Section 80IAC of Income Tax Act 1961

Exemption for the purpose of Section 56 (2) (viib) of the Act²³

Under the Notification a start-up will be exempted from the provisions of Section 56 (2) (viib) of the Act if it fulfils three conditions which are mentioned below:

- i. **Recognition by the DPIIT:** A start-up is required to make an online application with the Department for Promotion of Industry and Internal Trade ("**DPIIT**") and include along with the application, a summary about the nature of its business highlighting how it is working towards innovation, development, or improvement of products or processes or services, or its scalability in terms of employment generation or wealth creation. The DPIIT has the authority to recognize the entity as a "start-up" or reject the application accordingly.
- ii. **Aggregate Share Capital:** The aggregate amount of its share capital and the share premium after issue or proposed issue of shares is capped at Rs. 25 crores.

As per the Notification, any investment by a non-resident or by a venture capital company or venture capital fund will not be included in calculating the aggregate paid up capital. Further, any consideration received for shares issued or proposed to be issued to a listed company (having a net worth of Rs 100 crores or turnover of at least Rs 250 crores in the financial year proceeding the year in which shares are issued) will also be exempt from such computation.

(iii) **Prohibition on Certain Investments:** The third condition required to be fulfilled is that the entity has not invested in any of the following assets²⁴:

- building or land (residential), unless it is being used for the purposes of renting or held by it as stock-in-trade, in the ordinary course of business;
- building or land (non-residential), unless it is being occupied by the start-up for its business or used for the purposes of renting or held by it as stock-in-trade, in the ordinary course of business;
- loans and advances, other than loans or advances extended in the ordinary course of business by the start-up where the lending of money is substantial part of its business;
- capital contribution made to any other entity;
- shares and securities;

²³ *Relief to start-up companies from Angel Tax* dated February 20, 2019 <https://elplaw.in/wp-content/uploads/2019/02/ELP-Alert-Start-up-Notification-by-DPIIT-edited-002.pdf>

²⁴ **India: Tax Exemptions For Start-Ups Notified- 28 February 2019.** <https://www.mondaq.com/india/tax-authorities/784736/tax-exemptions-for-start-ups-notified>

- motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds Rs. 10 lakhs, other than the one held for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business;
- jewellery other than as required as stock-in-trade in the ordinary course of business; and
- any other asset, whether in the nature of capital asset or otherwise, of the nature of archaeological collections, drawings, paintings, sculptures, any work of art or bullion.

The above stated exceptions are valid for a period of 7 years from the end of the latest financial year in which shares are issued at premium²⁵.

Recent Announcement and scraping of the Angel Tax

The finance Minister of India Mrs Nirmala Sitaraman made a public announcement in early August 2019 exempting start-ups from the Angel Tax under section 56(2) of IT Act for start-ups registered with DPIIT (Department of Industrial [Policy](#) and Promotion).

According to the announcement though the section will not be applicable to Start-ups it will very well continue since this is important and vital to the Income Tax.

IV. CONCLUSION AND MY OPINION

Start up in India have witnessed several ups and downs with respect to the Angel laws. Liberalising the angel tax exemption conditions is a great initiative undertaken by the Government since start-ups are growing at a rapid pace. Also lessening of the scrutiny has reinstated the confidence of young entrepreneurs. Having said that, there is still a long way to go and better reforms to come up with to boost the Start-up in India. And the Government should come up with better initiative to challenge the conventional edges of that are being faced by start-ups.

²⁵ IDIB note 21 at 10