ANGEL TAX ON INDIAN START-UP's

Gadde Shareesh
CMA Final Student

Introduction:

An Angel investor (also known as informal investor) is a prosperous high net worth individual who contributes capital for a business start-up, usually in return for equity shares. These Angel Investors uses their personal expendable finance and experience to invest in the development of a small business, normally during start-up or early stage business. These investors can make funding on their own or as part of a group, usually led by a main angel investor. It is not necessarily required to make an investment into a company but they also can share their knowledge, experiences add value to their Start-up companies.

India has witnessed growth in start-ups for the last few years, and the government has created better environment through legal Measures. India's ranking in the World Bank's ease of doing business has gone up from 130 to 100 laying the foundations for a thriving start-up ecosystem[1]. However, capital plays major role at the early stage of business start-ups. And angel investing was the trending investment source for Indian start-ups.

Concept of Angel tax was introduced by then finance minister in union budget 2012, to curb money laundering of funds in India economy. **'Angel Tax'** refers to section 56 (2) (viib) of the Indian Income Tax Act, 1961, wherein the Income Tax Authorities are challenging additional taxes from Start-up Companies who have received financial support from Indian Angel Investors at a valuation higher than what can be ascertained for an early stage start-up venture.

Budget Memorandum 2012 proposed to insert a new clause in section 56(2) of Income Tax Act 1961, which apply to a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares. In such a scenario if the consideration received for issue of shares exceeds the nominal value of such shares, the total consideration received for such shares as exceeds the fair market value of the shares shall be liable to tax under the head **"Income from other sources"**.

How It Impact Start-ups:

Shares issued to the investor has be valued to decide whether the price exceeds the fair market value. The industry has necessitated that the discounted cash flow (DCF) method of evaluation be used to calculate angel tax instead of the net asset value (NAV) method. The valuation of a start-up business is usually based on a merchant negotiation between the company and the investor, and is an outcome of the company's projected earnings at that point in time. However, since Startup's drive in a highly ambivalent environment, many firms are not always able to perform as per their financial projection. Equally, some Startup's exceed the projection by a long mile if they are doing good.

Recent Government Measure to promote Start-up Businesses:

Department for Promotion of Industry and Internal Trade has issued notification dated 19th February 2019 amending the definition of Startup's and also provided certain relaxations for availing exemption from angel tax. Changes in the notification is as follows:

[1] World Bank (2017). Retrieved from https://www.worldbank.org/en/news/press-release/2017/10/31/india-jumps-doing-businessrankings-with-sustained-reform-focus. Last accessed on 19th October 2018

a) Start-up Definition: An entity can be considered as start-up if it satisfies below conditions:

- Turnover of start-up entity does not exceed hundred crores from the date of incorporation/registration.
- Start-up entity has to be incorporated as a Private Limited Company under companies Act 2013 or registered as partnership firm under Partnership Act 1932 or a limited liability Partnership (LLP) under LLP Act 2008 in India and continue for a period of Ten years.
- Entity should be able to generate employment opportunities or wealth creation through a business model with innovation, development or improvement of products as well of services.

b) Recognition process of Startup's:

- Entity has to make online application in the portal setup by the Department for Promotion of Industry and Internal Trade.
- Such application should consist, a copy of Incorporation/registration certificate of entity and write up about the nature of business by highlighting its working towards generating employment opportunities or wealth creation
- DPIIT may if it deems fit approve eligible entity as start-ups or rejects the application by providing reasons.

c) Section 80-IAC Certificate under Income-tax Act, 1961:

For the purpose of obtaining certificate under section 80-IAC of Income Tax Act 1961, being a private limited company or limited liability partnership which fulfils conditions specified under the said section has to make an application in Form-1 along with documents specified by DPIIT. Board may admit or reject the application based on documents and enquiries.

d) Exemption conditions for clause (viib) of sub-section (2) of section 56 of the Act:

A Start-up will be eligible under clause (ii) of the proviso to clause (viib) of sub-section (2) of section 56 of the Income Tax Act, 1961 and subsequent exemption from the provisions of that clause, if it satisfies the following conditions:

- Entity has been recognised by DPIIT or as per any earlier notification
- Paid up share capital and share premium of the start-up does not exceed twenty-five crore rupees
- It has not invested in building or land appurtenant thereto, being a residential house; loans and advances; capital contribution made to any other entity; shares and securities; a motor vehicle, aircraft, or any other mode of transport, on which actual cost doesn't exceeds ten lakh rupees; jewellery; other than that held by the Start-up as stock-in-trade in the ordinary course of business.

Conclusion:

India is the second largest start-up hub in world in terms of number of business promotion. While government aims to achieve Make in India concept, but start-up sector is facing tax scrutiny which is unnecessary and dangerous for the financial health of businesses. Since the introduction of Angel Tax, Startup's has impacted largely on Angel investments. Government can adopt other measures to curb money laundering like KYC and other documentary evidences other than burdening all start-ups businesses.