Angel Tax and Relief, From which Angle!?

Closely held companies which have raised equity from angel investors are being questioned by authorities to justify the premiums, failing which the premiums are being taxed under section 56(2)(viib) of the Income-tax Act, 1961. While this provision was brought to curb unaccounted money, it is being blindly used to tax an otherwise capital account transaction, even in the absence of existence of unaccounted money. This myopic approach, no doubt might garner revenue in the short term, but, in the long run, will definitely hurt the investor-friendly image of India. Taxation should be on the fruits of capital and not on the capital itself. If this continues, we might end up killing the hen laying golden eggs. Read on to know more…

One of the major challenges for an entrepreneur is raising capital. While banks and financial institutions have, to a certain extent, quenched the entrepreneurs' thirst for capital, the real saviour has been the entrepreneurs' private network.

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Entrepreneurs operating as Private Limited Companies ("PLC") continue to bank on their private network to raise capital. In such cases, the most preferred route for PLCs to raise capital from private network is Equity. Normally, when a young PLC raises equity, both the PLC and the investors are agreeable that management rights should continue with the promoter. For this non-Shylock attitude, the investors are graciously termed as "angel investors". Such angel investments are effected through allotment of shares at a premium. The premiums are normally back-of-the-envelope and vary sporadically from time to time.

While raising capital without proportionate management dilution is the genuine reason for PLCs to issue shares at a premium, the darker side is that share premium route has been misused by some to wash their ill gotten and unaccounted money. To curb this misuse, two important amendments were made to the Income-tax Act, 1961 in the year 2012 – firstly, through amendment to Section 68, if the PLC is unable to explain the source of investment of the investor, the PLC is taxed on the amount raised through allotment of such shares and secondly through Section 56(2)(viib), if PLC allots shares at a price higher than its Fair Market Value ("FMV"), the difference between the issue price and the FMV would be taxed in the hands of such PLC. It is interesting to note that the Memorandum to the Finance Bill 2012, lists both these amendments under *"Measures to prevent generation and circulation of unaccounted money"* – the mischief which the two amendments set out to cure.

While the means and end of the first amendment is genuinely to prevent generation and circulation of unaccounted money, the same cannot be said about Section 56(2)(viib). The problem with Section 56(2)(viib) is two-fold – Firstly, PLCs have to justify the share premium even in the absence of indications of unaccounted money and secondly the means provided to justify the issue price is too limited - either the Book Value method ("BV") or the Discounted Free Cash Flow method ("DFCF").

The problem with Section 56(2)(viib) is two-fold – Firstly, PLCs have to justify the share premium even in the absence of indications of unaccounted money and secondly the means provided to justify the issue price is too limited - either the Book Value method ("BV") or the Discounted Free Cash Flow method ("DFCF").

Fundamentally, issue of shares is a capital account transaction which should not be taxed in the first place. Useful reference can be made to the recent Vodafone and Shell rulings rendered by the Bombay High Court, which Central Board of Direct Taxes (CBDT) has ultimately accepted. However, CBDT in order to curb generation and circulation of unaccounted money has introduced angel taxation. In genuine investment cases where both the investor as well as the source of investment is sacrosanct, is it valid to tax a capital account transaction just because the PLC is unable to justify the issue price? A doctor administers medicine only when there exists evidence of ailment. Taxing a PLC which is unable to justify the share premiums in genuine investment cases would be akin to a doctor administering medicine because the otherwise healthy person is not able to prove that he does not have any ailment. The cure should be applied when there exists evidence of mischief. The cure should not be applied when there does not exist any signs of non-existence of mischief.

The other problem with angel taxation procedure is with the limitations of the means provided by CBDT to justify the share premium. While the BV does not take into consideration the future earning potential, the DFCF is dependent on too many variables. As beauty lies in the eyes of the beholder, so is value the acumen of the valuer. Having said that, valuation methods are not completely theoretical and subjective. The real world definitely uses the valuation methods to get a fair idea of the transaction price. The values churned by various valuation methods are only indicative. These indicative values are further negotiated upon and finally the transaction price is agreed. This negotiated transaction price might not be the same as the value arrived at by using BV or DFCF. Consequently, if an aggressive entrepreneur has been able to convince the investor for a price higher than the value arrived at by using the BV or DFCF, the PLC might end up paying angel tax. Is this a transaction worthy of tax? The point is, valuation

methods are at best of academic significance. As Nassim Nicholas quips, *"In academia there is no difference between academia and the real world, in real world there is."*

Recently concluded assessments have shown the ill effects of equipping Assessing Officers (AO) with such subjective rules. The AOs have gone one step ahead by disputing the assumptions of the independent valuations reports provided by the PLCs and have raised demands for angel tax on the basis of their own assumptions. This approach has found the sanction of Delhi ITAT in the case of Agro Portfolio Private Limited. The ITAT has however not considered the Honourable Supreme Court's decision in the case of Miheer H. Mafatlal V. Mafatlal Industries Limited case where it was held the Court has neither the expertise nor the jurisdiction to delve deep into the commercial wisdom exercised by parties. In all this zeal the very purpose of Section 56(2)(viib) of preventing generation and circulation of unaccounted money has been forgotten. Or has it been conveniently ignored?

It is not that CBDT is unaware of the issue. However, in the garb of providing relief, CBDT, seemingly has sort of complicated the matter. CBDT has notified that allotment of shares by "Start Ups" shall be immune from angel taxation. Department of Industrial Policy and Promotion (DIPP) in turn has put in place an approval process whereby recognised start-ups, on application, will be granted amnesty from angel taxation. This brings us to an important question – What about angel investments into PLCs which are not DIPP recognised start-ups? Further, what about angel investments into DIPP recognised start-ups which have either not applied or on application have not been granted the angel-tax protection? Do such PLCs still have to justify the share premiums using the limited means notified?

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The so-called relief would lead to a situation wherein a PLC which is not a DIPP recognised start-up or a DIPP recognised start-up which has not applied for approval will blindly be assessed for angel tax even in the presence of independent valuation reports despite there being no evidence of unaccounted money. This will further burden our already over-worked dispute resolution machinery.

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Instead, would it not be wiser if one invokes the provisions of Section 56(2)(viib) if and only if there exists evidence of the mischief – existence of evidence of generation and circulation of unaccounted money. If the investor or the investor's source is not identifiable, then Section 68 would tax the PLC and Section 69, the investor. Further, only in such cases of share allotments where Section 68 is attracted, if the PLC is also not able to justify the FMV, let there be an additional tax under section 56(2)(viib). However, if there does not exist any evidence of unaccounted money, then let Section 56(2)(viib) be left to rest in peace. In other words, evidence of unaccounted money should be quintessential for invoking Section 56(2)(viib).

Anti-abuse provisions are essential, but not abuse of the anti-abuse provisions. Anti-abuse provisions are not norms, but exceptions which should be invoked only in exceptional circumstances.■

The art of being happy lies in the power of extracting happiness from common things. - Henry Ward Beecher