Taxing Non-Resident Angel’s – Implications of India’s changes to angel tax and implications on foreign investors.

written by Rajesh Sivaswamy | August 9, 2023

Effective April 1, 2023, any private company that receives funding from a non-resident investor at a premium above the fair market value of its shares as per the Income-tax Act, 1961 (the "**Act**"), will have to pay tax on the excess amount as income from other sources under section 56(2)(viib) of the Act. This means that from April 1, 2023, any investment made by a non-resident in an unlisted company at a premium over the fair market value of the shares will be taxable as income from other sources in the hands of the company.

Given that the startups in India are witnessing a funding winter, this amendment is likely to have a significant impact on the foreign direct investment (FDI) inflows into India.

Background:

While the concept of Angel tax was coined in 2012 as an anti-abuse measure to prevent the use of unaccounted money for funding startups and other companies, the net has now been widened by the Finance Minister in the Budget 2023. The tax has been widely debated by the startup community and investors for being arbitrary, regressive and detrimental to the growth of entrepreneurship and innovation in India.

In response to these concerns, the government has introduced some relaxations and exemptions for angel tax in recent years. For instance, in 2019, the government announced that startups registered with the Department for Promotion of Industry and Internal Trade (**DPIIT**) would be exempt from angel tax, subject to certain conditions. In 2020, the government also increased the turnover limit for startups eligible for angel tax exemption from Rs 25 crore to Rs 100 crore.

Key Concerns

The extension of angel tax to non-residents has raised several concerns and questions among foreign investors and Indian companies. Some of the key issues are:

- The amendment will create a conflict between the Act and the Foreign Exchange Management Act, 1999 (the "**FEMA**"). Under FEMA, foreign investors are required to invest in Indian companies at a price not less than the fair valuation of the shares as per internationally accepted pricing methods, such as discounted cash flow (DCF) or net asset value (NAV). However, under the Act, the fair market value of the shares is determined by a different formula based on book value or DCF as per income tax rules. This may result in a situation where a foreign investor complies with FEMA but still attracts angel tax under the Act.
- The amendment will also affect the valuation of convertible instruments, such as debentures or preference shares, which are commonly used by foreign investors to invest in Indian companies. These instruments are usually convertible into equity shares at a predetermined price or ratio, which may be higher than the fair market value of the shares at the time of conversion. Under the amendment, such conversion may trigger angel tax on the difference between the conversion price and the fair market value of the shares.
- The amendment will also impact the exit options for foreign investors who want to sell their shares in Indian companies. If they sell their shares at a price higher than the fair market value of the shares as per the Act, they may have to pay capital gains tax on the difference.

However, if they sell their shares at a price lower than the fair market value of the shares as per FEMA, they may have to obtain prior approval from the Reserve Bank of India (RBI) or face penalties for violating FEMA.
- The amendment will also create uncertainty and litigation for foreign investors and Indian companies. The determination of fair market value of unlisted shares is not an exact science and may vary depending on various factors and assumptions. The tax authorities may challenge or dispute the valuation adopted by the parties and demand additional tax or penalties. This may lead to prolonged disputes and litigation, which may hamper the ease of doing business in India.

Observations:

The extension of angel tax to non-residents is a retrograde step that may discourage foreign investment in India and hurt the startup ecosystem. The government should reconsider this proposal and provide clarity and relief to foreign investors and Indian companies. Alternatively, valuation methods under FEMA and the Act should be aligned and exemptions or concessions provided for genuine transactions that promote innovation and entrepreneurship in India. Given the past record of the tax man in India, the government should also provide clarity on how this amendment will affect existing investments and whether there will be any grandfathering or transitional provisions.

FAQs

What is the recent change in India's angel tax regulations?

Effective April 1, 2023, any private company in India receiving funding from a non-resident investor at a premium above the fair market value of its shares, as per the Income-tax Act, 1961, will have to pay tax on the excess amount as income from other sources under section 56(2)(viib) of the Act.

What is the background of angel tax in India?

Angel tax was introduced in 2012 as an anti-abuse measure to prevent the use of unaccounted money for funding startups and companies. The concept has evolved over the years with certain exemptions and relaxations introduced for startups.

How does this change impact non-resident investors?

This amendment implies that any investment made by a non-resident in an unlisted company at a premium over the fair market value of the shares will be taxable as income from other sources in the hands of the company.

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