Taxing The Angels: Stifiling The Indian Start-up Eco-system
written by Rajesh Sivaswamy | February 20, 2019

"Fine is a tax for doing something wrong, Tax is a fine for doing something right"- This perhaps sums up the on-going conundrum surrounding angel tax in India.

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Introduction

Post liberalisation in 1991, the Indian economy grew in the high single digits for several years. In the year 2016, India was conferred with the tag of the world's fastest growing economy. Though demonetisation in November 2016 temporarily displaced India from pole position, it was widely christened that India was the new land of opportunities. It was this sudden realisation, along with the lost opportunities in China that had global VC firms making a beeline to invest into Indian opportunities and kicking off a frenzy of venture capital action.

The venture capital industry in India has evolved and matured significantly and the industry expects and rightfully so that the Government of the day through a combination of pragmatic policy-making and execution focus, accelerate this journey. Angel investors are the corner stone on which a start-up ecosystem is built and grown and they are the ones who take the initial risks on emerging start-ups and while such risks are assumed, the investments that these angels make lend much needed third party credence and validation for start-ups. Angels thus play a vital role in the start-up eco-system and fuel the journey for the start-ups of the future. However, over the last few months, Angel tax has consumed the start-up ecosystem and has become a new buzzword.

Genesis of Angel Tax

Section 56(2)(viib) of the Income Tax Act 1961 provides that the amount raised by a start-up in excess of its fair market value would be deemed as income from other sources and would be taxed at 30 per cent. The section was introduced in 2012 under the Finance Act, 2012 and was touted as an anti-abuse measure.

When start-ups receive investments at a premium to the fair price, Indian tax laws have held that the amount raised in excess to the fair value is taxable. The amount is reckoned as "income from other sources" and taxed under Section 56 (ii) of the Income Tax Act at a hefty 30.9 per cent and applied not just to mature private companies, but also to small start-ups that took early-stage investments from residents in India. Though the entire investment is not taxed, anything considered above 'fair value' is and this leaves start-ups vulnerable since taxman feels the investment is too high over their valuation.

In June, 2013- the Securities and Exchange Board of India ("SEBI") under the SEBI AIF (Alternative Investment Funds) Regulations, 2012 recognised angel funds, as funds raised by unlisted entities from angel investors. It also provided that SEBI-registered angel funds in approved investee companies would now not be taxable even if it is above the fair market value. Subsequently, in June of 2013 SEBI restricted the investments to amounts between Rs. 50 lakhs and Rs. 5 crores and further mandated that angel investors could only make investments in companies that are incorporated in India which have a maximum turnover of Rs. 25 crores and a minimum of Rs. 10 crores.[1] Between 2013 to 2018 several committees considered the implications of angel tax and made recommendations which culminated in 2018 when the Department of Industrial Policy and Promotion ("DIPP") announced exemption on angel tax. Angel funds can now avail tax relief over issues of shares in excess of the fair market value[2] if the aggregate amount of paid-up share capital and the share capital of a start-up post issue does not exceed Rs. 10 crores[3] [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.

Start-ups – Global scenario

Governments globally are recognising the usefulness of encouraging and inviting angel investors to boost their startup economies. To this end, many global start-up hubs in fact offer tax cuts and incentives to attract angel investors. China, for instance is built on the foundation of start-ups several of whom are house hold names today including the likes of Baidu, Tencent, and Alibaba, a few well-known names that have emerged from the Chinese market. These unicorns have been able to prosper thanks to preferential tax policies that permit 70 percent of total investment to be deducted from taxation two years after investment in high-tech start-ups. Countries like Singapore also offers substantial tax incentives to start-ups and investors, even offering qualifying start-ups up to Singapore $200,000 tax exemption on their first three consecutive years of assessment. This has prompted several Indian start-ups to move their bases to Singapore in the last few years.

Even advanced economies such as Germany and UK have passed laws and implemented policies that offer generous tax incentives to start-ups and angel investors. As opposed to the idea of taxing angel investors, investors in countries such as US are actually offered tax benefits when they fund small companies. Against this backdrop, the problems posed by India's angel tax has become a nightmare for companies that are trying to build silicon valleys in our backyard.

Core of the Issue – Valuation methodologies?

Valuation surrounding start-ups has always been tricky. On the one hand is the entrepreneur who has just set-up his/her business from the ground-up and on the other hand, the angel investor who is trying to size up the business potential for growth, expansion and ultimately exit. All of this based on the limited assets of the start-up, given valuation of intangibles such as goodwill is not easy. Nor is it easy to derive at a 'fair value'. Therefore, start-ups are often valued subjectively and the resulting valuation seems sky-high to some, may be fair to others. Valuations when derived must also be juxtaposed with the vision of the founder entrepreneur who does not want to dilute heavily in a seed round and higher valuations, are directly beneficial as it means giving up less equity.

The context of valuation bears relevance given that the majority of Indian start-ups opt for the Discounted Cash Flow (DCF) method of valuation instead of the Net Asset Value (NAV) method while raising capital. Start-ups find it challenging to explain the valuation and credit amounts claimed per Section 68 of the Income Tax Act since most assessing officers refuse to accept the DCF method of valuation.

One also has to appreciate the regulatory quagmire in India where the policy in relation to start-ups are formulated by the DIPP under the Ministry of Commerce and Income tax comes under the purview of the Department of Revenue (DoR) of the Indian government's Ministry of Finance. It is the Central Board of Direct Taxation (CBDT) under the DoR which implements and executes policy in relation to income tax. While the DIPP has been appreciative of the challenges facing the start-up eco-system, the CBDT has been largely apathetic towards their problems.

After the DIPP took the matter to the Ministry of Finance, the CBDT in February 2018 issued a notice that no coercive action would be taken against start-ups that have adopted the DCF method. Despite these measures start-ups are at the receiving end of I-T notices and demand orders despite all these notifications by the DIPP and the CBDT. There have also been instances which have come to light - travelkhana and babygogo where the taxman has taken the liberty of taking money directly from their accounts.

Missed opportunities

Benjamin Franklin rightly quoted that, "In this world nothing is certain but death and taxes". In the backdrop of opposition to the angel tax, there was a genuine expectation by entrepreneurs and angel investors of certainty in this year's budget. Expectations ranged from outright abolition to reduced taxation rates and overall a better clarity on the angel tax regime. However, hopes were dashed since the budget made no significant announcements in this regard.

Over the years, tax uncertainty around raising funds only forced companies attracting foreign investment, like Flipkart, Razorpay and Practo, to shift headquarters out of the country and it is hurting the start-up ecosystem the most. Purposeful tax deduction is to leave more money where it belongs: in the hands of the working entrepreneurs who earned it in the first place. The key to revenue growth is a tax reform that closes loopholes and that is pro-growth. Then with a growing economy, that's where your revenue growth comes in, not from higher taxes. In the absence of any empirical evidence demonstrating money laundering [for which the angel tax provision was first intended], presuming every angel investor paying premium or getting discount should not be deemed criminal and penalised.

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Footnotes

1 https://www.sebi.gov.in/media/press-releases/jun-2013/sebi-board-meeting_24942.html

2 https://dipp.gov.in/sites/default/files/lu2646.pdf

3 https://dipp.gov.in/sites/default/files/Startup_Notification11April2018_0.pdf

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