Angel Tax and others

What you should know and how should you prepare

September 2020

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Agenda

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01 What is Angel tax and why was it introduced

02 Available reliefs to start-ups

03 The added dread of section 68

04 Income-tax provisions to aid start-ups

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Lets get started...

The magical moment

You've got the idea and are buzzing with energy

It works !

Your idea has been validated with first customers and it works.

The Eureka moment

This is the magical point where the idea has proved its worth and there is a ready market for it.

Congratulations

You've done it and now its time to scale-up, gather your team and resources

Typically done through corporatizing the entity into a private limited company and raising funds through issue of equity shares/compulsorily convertible preference shares. The angels you approach value your company not with the assets it holds today but through the untapped potential it has which could be multiples of its present asset value – angel tax steps in

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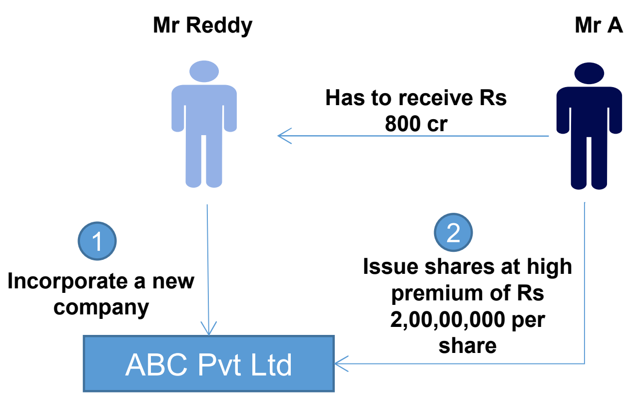
Why section 56(2)(viib)

Mischief prior to 2012



Resulting shareholding after step 2

Shareholder	No of shares	Amount infused	%
Mr Reddy (and through a representative)	10,000	1,00,000	96%
Mr A	400	8,00,00,00,000	4%

	Impact
1	Mr Reddy has received Rs 800 crore from Mr A without any tax and converting an illegal receipt into a legal receipt - receiving the money directly would have attracted tax and was illegal
2	Mr Reddy has been able to take control over the funds with just 4% dilution – a very small cost in the whole scheme of things
3	Prior to 2012, tax authorities did not have any power to question the issue price

Comes sec 56(2)(viib)

The issue price needs to be substantiated by a valuation report either on tax NAV basis or DCF. Any difference between the fair market value and issue price to be considered as income in the hands of the recipient company.

Report on DCF valuation is to be issued by a Merchant Banker

Section 56(2)(viib) – 'Angel Tax'

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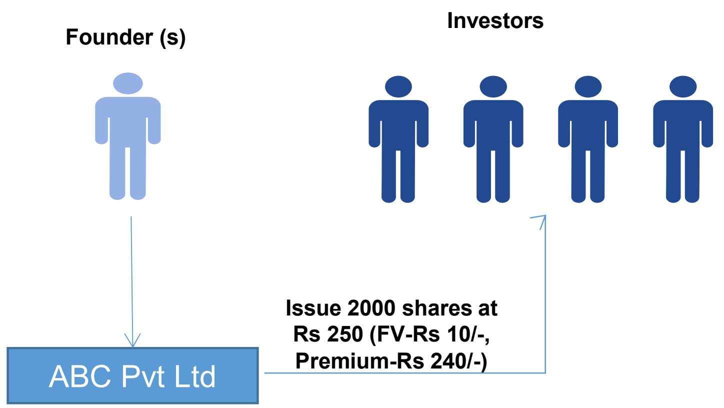
- Introduced in 2012
- General Rule: Where a private limited company receives from a resident person, any consideration for issue of shares that exceeds the face value of the shares, the difference between the fair market value of shares and the aggregate consideration received for such shares shall be taxable in the hands of the recipient company
- The method to calculate fair market value is either through a prescribed method or as substantiated to the satisfaction of the tax officer **WHICHEVER IS HIGHER**.
- Prescribed methods are – Tax NAV or DCF valuation determined by a merchant banker – option of the assessee

Case Study: Magnus Private Limited entered into a SHA for issue of shares of Rs 100 each (face value) at Rs 4000 (Issue price). The value of the company computed by a merchant banker as per DCF method is Rs 2500.

Rs 4000 (Issue price) – Rs 2500 (fair market value) = Rs 1500 ⇒ considered as income in the hands of the recipient company. Tax to be paid on Rs 1500 at corporate tax rate.

Angel Tax – a case study



- Tax officer challenges the issue price of Rs 250/- per share
- Addition made in the hands of the company under sec 56(2)(viib) = Rs 4,80,000/- (2000 shares x Rs 240)
- Tax demand on addition @ 26% = Rs 1,24,800/- plus interest + penalty proceedings
- Even if the company wants to go for appeal 20% of the tax demand has to be deposited before filing of appeal

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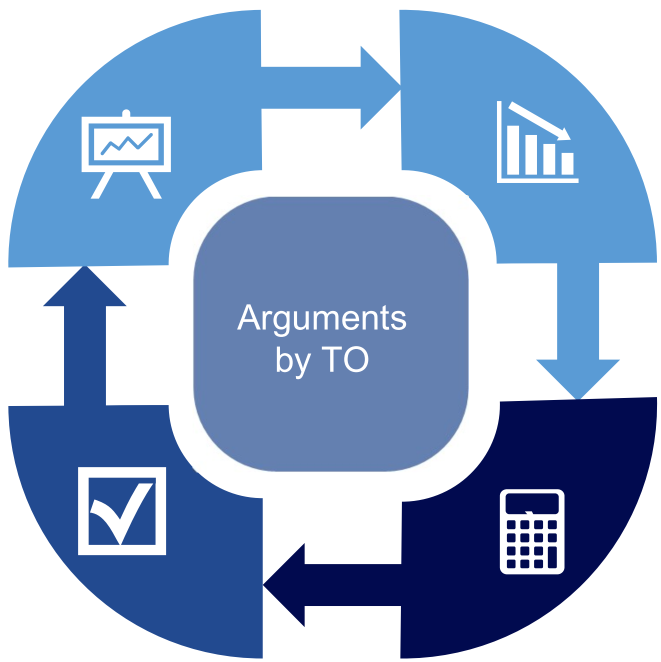
Grounds of TO challenging valuation

Assumptions are challenged

DCF valuation involves relying on several assumptions and estimations which may be rejected by the TO on the ground that they do not reflect the true value

Sea of difference between actual figures and projections

There could be a huge difference between the projections that were made at the time of issue of shares and the actual performance of the company which makes the TO doubt the underlying assumptions



Projections and assumptions not verified by the valuer – mechanical approach

Projections are provided by the management, the underlying assumptions of which are not verified by the valuer .

NAV is fact based and reveals a accurate value

Net asset value is computed on the basis of assets owned by the company and is based on factual data which reveals a more accurate value of the company

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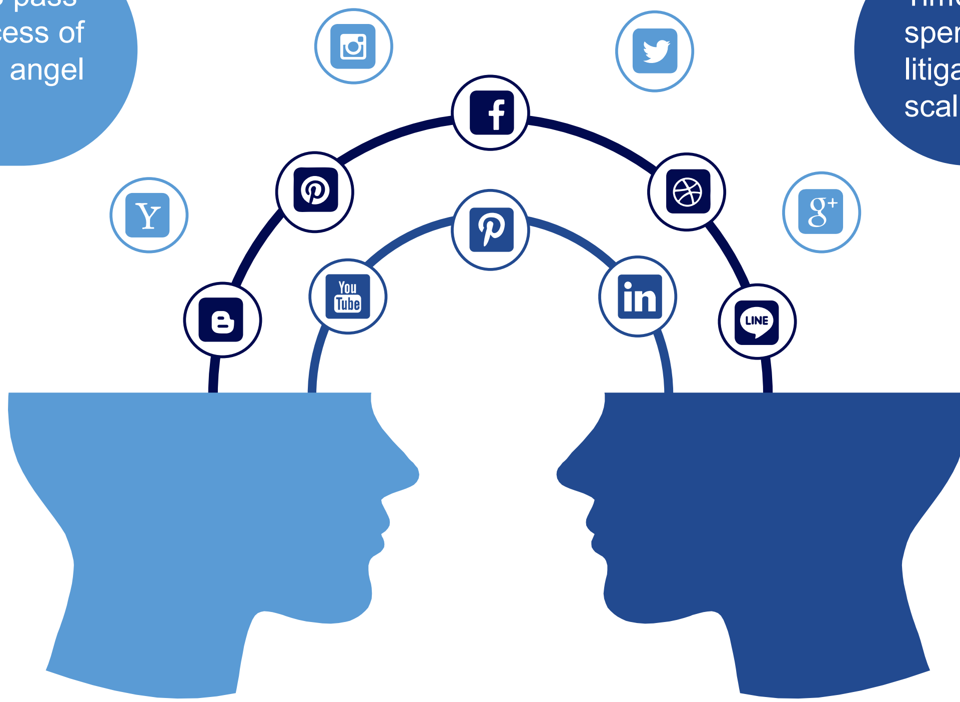
Why was it especially difficult for start-ups

Start-ups had to pass through the process of assessments on angel tax issue

Time of founders spent on managing litigations rather than scaling business



If addition was made at assessment stage, the start-up would have to deposit 20% demand before even filing an appeal

The fund raised for fueling the initial stages of scaling gets eaten up by tax demand and professional's fee

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Exceptions and relief for start-ups

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Journey with angel tax

2012

Angel tax introduced

Exceptions provided

Venture capital undertaking from VCC or VCF; and
Company from notified class of persons

2016

Start-up India initiative – N.N. GSR 180 (E), 17/2/2016

-Start-up India team launched reporting to DPIIT
-Start-up defined
-Tax benefit u/s 80IAC wef 1/4/2017

2017

N.N. GSR 501(E), 23/5/2017

Definition of start-up widened

2018

Relaxation from Angel tax

-CBDT circular for no coercive action against start-ups on angel tax – 6/2/2018
-DPIIT notification on procedure for applying for relaxation from angel tax and benefit u/s 80IAC – N.N. GSR 364(E), 11/4/2018

2019

Exceptions provided

- Definition of start-up widened further,
- Eligible start-ups notified for exemption from angel tax – DPIIT NN GSR 127(E), 19/2/2019 read with NN S.O 1131(E) date 5/3/2019

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Start-ups defined

As it stands today – considered as start-up upto 10 years

Entity criteria	Turnover criteria	Business activity	Ceases to be a start-up
Private Limited company defined under Companies Act 2013	Has not exceeded Rs 100 crore in any year since incorporation	Working towards innovation, development or improvement of products or processes or services	Completion of 10 years from incorporation
Limited liability partnership under LLP Act, 2008		A scalable business model with a high potential of employment generation or wealth creation.	Turnover for any year exceeds Rs 100 crore
Partnership firm registered with Registrar of Firms under Partnership Act, 1932			

What will/will not fall under this activity ?

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What you have to do to avail exemption

1. Satisfy the condition of start-up

- The entity must be a private limited company or a LLP or a partnership firm
- Turnover should not be more than Rs 100 crore
- Must be engaged in eligible business

2. Make an application to DPIIT for recognition as start-up

- Certificate of incorporation
- a write-up about the nature of 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.

3. Make an application to DPIIT for exemption from angel tax

- Recognized by DPIIT as start-up
- Aggregate share capital and share premium after issue or proposed issue <= Rs 25 crore
- Has not invested in certain specified assets within 7 years from the latest financial year in which shares were last issued at premium
- File a declaration in Form 2 with DPIIT. DPIIT to forward declaration to CBDT

Impact

No angel tax assessment irrespective of the date of issue of shares except where addition already made before issue of notification

Separate CBDT clarification on how to deal with additions made in respect of recognized start-ups prior to Feb 2019 and matters pending in assessment

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The added dread of section 68

What is section 68

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- Where a sum is found credited in the books of an assessee maintained for any previous year;
- and the assessee offers no explanation about the nature and source of the credit or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory;
- the sum so credited may be charged to income-tax as the income of the assessee of that previous year
- <u>Extra onus on private limited company in case of share application money:</u> Incase of a private limited company where the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless—

  (*a*) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and

  (*b*) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:

  <u>Exception for VCF and VCC</u>: Provided further that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (*23FB*) of section 10.

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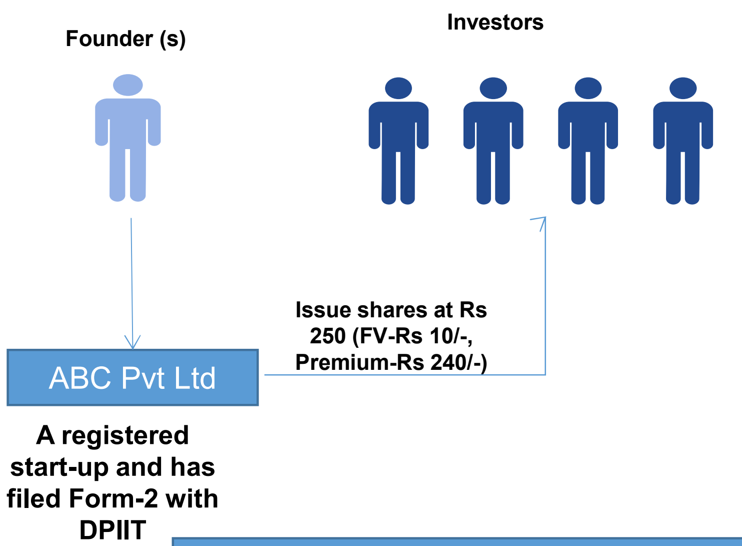
What is section 68



- NO EXEMPTION FROM SECTION 68 FOR START-UPS
- ADDITION MADE UNDER SEC 68 TAXABLE AT 60%
- NO SET OFF OF LOSSES ALLOWED
- MUCH MORE ONEROUS THAN ANGEL TAX

Exemption from angel tax

Angel tax not applicable because the start-up is recognized by DPIIT and declaration under Form-2 has been filed

BUT

Section 68 may be invoked

Onus on start – up

To prove the nature and source of credit AND source of source of share application .

How to prove nature and source

The start up company will have to prove the following in order to discharge its initial onus cast under section 68 :

- Identity of investors
- Genuineness of transaction
- Creditworthiness of investors

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Discharging initial onus

Your tax notice may look something like this

2) **Large share premium received during the year (verify applicability of Sec 56(2)(viib)).**

a) With respect to increase in share capital/premium the information in the following format may be furnished.

S.No	Name and address of the shareholder	PAN	Face value of each share	Premium on each share	No. of shares allotted	Total value of allotted shares	Payment received till 31.3.2016		Payment received during F.Y. 2015-16	
1	2	3	4	5	6	7	8		9	
							On account of Share capital	On account of Share premium	On account of Share capital	On account of Share premium

b) Also furnish:

(i) The proof of identity and creditworthiness the shareholders as well as the proof of genuineness of transaction in respect of fresh credit of the share capital/premium account.

(ii) The working and quantum of Book Value of Shares and justification for the quantum of premium. Attach valuation report from certified valuer.

(iii) The comparison of the working and quantum of Book Value of Shares and share premium with the immediately prior instance, wherein the shares were allotted with premium.

(iv) The year wise details of dividend declared during the year and three earlier years.

(vi) Furnish certified confirmations from the investors, copy of ITRs of the investors from whom share application money/premium was received along with the bank statement of investors showing such debit entries to prove genuineness, credit-worthiness and identity of such investors.

(vii) The onus of proving identity, credit-worthiness and genuineness u/s 68 of I.T. Act is on you, hence, you are required to substantiate the source of share application money/premium by furnishing credible evidences in view of Section 68 of the I.T. Act, 1961.

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Discharging initial onus

Requirement of section 68 – assessee to explain the nature and source of credit and satisfy the tax officer with the same

Provision does not give any guidance as to how to prove the nature and source

- Identity of investors
- Genuineness of transaction
- Creditworthiness of investors

<u>Documents that should be submitted to discharge primary onus:</u>

1. Name, address and PAN details of all investors – identity revealed
2. Copy of Income-tax returns – helps to prove creditworthiness
3. Copy of Balance sheet or statement of affairs – helps to prove creditworthiness
4. Copy of bank statement – helps to prove genuineness
5. Confirmation of account

Other documents:
- Shareholder agreement
- Board minutes
- ROC filings
- Valuation report

Investors may not be willing to share sensitive information such as income-tax returns, balance sheet, bank statement etc. Do provide name, address and PAN details to reveal identity along with attempts made for obtaining other information. The tax department also has powers to directly obtain information from investors, provided the identity is properly revealed

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ITA provisions to aid start-ups

Section 79

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Relaxed criteria for carry forward of losses for start-ups

GENERAL RULE

Where there is a change in shareholding of a private limited company, no loss incurred prior to the relevant financial year will be allowed to be carried forward and set-off against income of the relevant financial year unless on the last day of the relevant financial year, shareholders holding 51% voting power also held 51% voting power of the company on the last day of the year in which the loss was incurred.

RELAXED RULE FOR START-UPS

An eligible start-up shall be allowed to carry forward and set off losses incurred prior to the relevant financial year if all the shareholders who were holding voting power on the last day of the financial year in which the loss was incurred also hold voting power in the year of set-off and the loss was incurred during 7 seven years from incorporation.

NO REQURIEMENT OF VOTING POWER OF 51% SINCE FOUNDERS/INVESTORS MAY BE DILUTED IN ROUNDS OF FUNDING

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Section 79

General rule

Year	Tax loss (in Rs)	Shareholding
1	(20)	A-10%, B- 10%, C-20%, D-60%
2	(40)	A-10%, B-10%, C-20%, D–60%
3	(30)	A-10%, B-10%, C-20%, E–60%
4	20	A-10%, B-10%, C-30%, E–60%

Relaxed rule for start-ups

Year	Tax loss (in Rs)	Shareholding
1	(20)	A-10%, B- 10%, C-20%, D-60%
2	(40)	A-10%, B-10%, C-20%, D–60%
3	(30)	A,B,C,D together hold 40%, investors hold 60%
4	20	A,B,C,D together hold 40%, investors hold 60%

Section 80IAC

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100% profits from eligible business exempt for 3 consecutive years within a period of 7 years

Conditions

Constitution
Must be a private limited company or a LLP – registered partnership firm, though recognized as start-up by DPIIT not eligible 80IAC

Incorporation
Must be incorporated between 1/4/2016 and 31/3/2021

Engaged in eligible business
Eligible business definition same as DPIIT

Certification
Must hold certificate of eligible business from Inter-ministerial Board of certification

Turnover
Turnover should not exceed Rs 100 cr in the relevant financial year

Not a reconstructed business
Not formed by splitting up or reconstruction of business already in existence

Old P&M should not have been transferred to new business
Must not be formed by transfer of old plant machinery into new business (second hand machinery ?)

Exception of old P&M upto 20% of total P&M
Condition shall be deemed to have been satisfed.

Section 54GB – exemption for investors

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Exemption from tax on long-term capital gains of an Individual or HUF on the sale of a residential property if such gains are invested in an eligible start-up

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Thus, if an individual or HUF sells a residential property and invests the capital gains to equity shares of eligible startups, then tax on long term capital will be exempt provided that such shares are not sold or transferred within 5 years from the date of its acquisition. The startups shall also use the amount invested to purchase assets and should not transfer asset purchased within 5 years(3 years in case of computer or computer software) from the date of its purchase. The post subscription shareholding or voting power of the subscriber should be more than 25%.

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Thank You