Easing of Conditions for Angel tax

Why in news?

Following the concerns raised earlier, the Centre has decided to ease the conditions for angel tax/taxing investments in start-ups.

What is angel tax?

- An angel investor is one who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity.
- In simple terms, angel tax is the tax levied on such investments made by external investors in startups or companies.
- At times, capital is raised by unlisted companies via issue of shares where the share price is seen in excess of the 'fair market value' of the shares sold.
- So the entire investment is not taxed but only the amount that is considered above “fair value” valuations of the startup.
- Currently, funds from angels are subjected to over 30% tax if it is more than the fair market value (FMV).
- It was introduced in the 2012 Union Budget to arrest laundering of illegal wealth by means of investments in the shares of unlisted private companies at extraordinary valuations.
- However, under certain conditions, exemption to startups is offered under Section 56 of the Income Tax Act.

What are the concerns with it?

- The share issued to an investor has to be valued to decide whether the price is in excess of fair value.
- The valuation of a startup is usually based on a commercial negotiation between the company and the investor.
- It is based on the company’s 'projected earnings' at that point in time.
- However, as startups operate in a highly uncertain environment, many are not always able to perform as per their financial projection.
- Equally, some companies exceed the projection if they are doing well.
- Resultantly, startups are often valued subjectively and it causes differing interpretations of “fair value”.
- Startups are thus vulnerable to unduly high taxes because the taxman feels the investment is too high over their valuation.

What are the new proposals?

- The proposals aim to simplify the process of exemptions for Startups under section 56 of the Income Tax act.
- An entity shall be considered a startup up to 10 years from its date of incorporation / registration instead of the existing period of 7 years.
- The turnover for any of the financial years since its incorporation/registration should not have exceeded Rs 100 crore (instead of the existing Rs 25 crore).
- All investments into eligible startups by Non-Residents, Alternate Investment Funds-Category I registered with SEBI shall also be exempt under Section 56 of IT Act.

How will it benefit?

- Stringent rules on angel tax have had an adverse effect on investor confidence in startups.
- So the relaxations will help the start-ups which are in desperate need for capital to fund their growth and other business requirements.
- Further, the new rules are set to be applied retrospectively.
- So many young companies that have received notices from the IT Department in the last few years will be relieved by the change in rules.

What are the continuing concerns?

- Companies wishing to make use of the latest exemption will first have to be registered with the government as start-ups.
- To be classified so, a company should not have invested in any land unrelated to the business, vehicles worth over Rs.10 lakh, or jewellery.
- These requirements (aimed at preventing money-laundering) can lead to considerable bureaucratic delays and rent-seeking.
- Also, the concerns with calculation methodology on evaluating the share prices against the fair market value are not addressed yet.
- Notably, it is impossible to know the market value, let alone the fair market value, of shares that are not openly traded in the marketplace.
- So despite the relaxations, the rules can again cause the old problem of arbitrary tax demands by tax authorities.
- In all, unless the government addresses the arbitrary nature of the angel tax, the damage to investor confidence may remain.

Source: Economic Times, The Hindu



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