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Income Tax

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CBDT proposes key amendments to neutralize the impact of Angel Tax – Revamp anticipated!

Snapshot

Finance Act 2023 extended the applicability of provisions of section 56(2)(viib) of the Income-tax Act, 1961 ("the Act") to non-resident investors. Accordingly, if a closely held company issues shares at a value higher than fair market value (FMV) of such shares (computed as per Rule 11UA of the Income Tax Rules) to non-residents, the excess of consideration received over FMV is taxable as income in hands of company. After interactions with stakeholders, CBDT now proposes to amend Rule 11UA to provide certain relaxations and also to exclude money received from certain non-resident investor entities from applicability of section 56(2)(viib). The key changes proposed include addition of five more valuation methods for non-resident investors, price matching guidelines with investment made by notified non-resident entities and venture capital funds/specified funds, safe harbor for variation up to 10% and non-applicability in case of certain class of investors like Government entities, banks and insurance companies. Investments in registered start-ups will also be out of the purview of section 56(2)(viib).

Background

As per the provisions of section 56(2)(viib) of the Act, where a company that is not a company in which public are substantially interested, receives any consideration for issue of shares which is higher than FMV of such shares, then excess of issue price over FMV is chargeable to tax as income under the head 'Income from other sources'. The FMV of unquoted equity shares is required to be determined as per mechanism as prescribed under Rule 11UA of Income Tax Rules, according to which, either Net Asset Value Method ('NAV') or Discounted Cash Flow ('DCF') method (by a Category I Merchant Banker) is to be followed, at the option of the taxpayer.

The objective behind insertion of section 56(2)(viib) vide Finance Act 2012 was to prevent generation and circulation of unaccounted money through share premium received by closely held company from resident investors in excess of fair market value of such shares.

Finance Act 2023 removed the phrase 'being a resident' from the said clause, thereby making the provision applicable to consideration for issue of shares received from non-residents as well. The proposed amendment is applicable from AY 2024-25 onwards.

This amendment could result into unintended consequences, for instance, in case of foreign investment received by startups, which are generally higher than FMV and scenario where fair value under FEMA regulations is higher than FMV as per Rule 11UA. FEMA norms require that foreign investment in India should not be lower than valuation determined as per any internationally accepted pricing methodology duly certified, whereas, under Income tax law, amount received by such closely held company exceeding fair market value under Rule 11UA is to be charged as income. There could be concerns from income tax perspective when FMV as per FEMA regulations is higher than that determined as per Rule 11UA.

In view of the above and other challenges, various stakeholders represented before CBDT in this regard. Consequently, CBDT has now proposed various changes to Rule 11UA and proposed to exclude certain entities, detailed as below.

Changes proposed to Rule 11UA and exclusion for specified entities:

Parameters / Considerations	Proposed Amendment	KCM Comments
Inclusion of other Valuation methods	Presently, as per Rule 11UA, valuation of unquoted equity shares is to be determined as per either NAV or DCF. CBDT has proposed to include five more valuation methods, for non-resident investors.	Keeping in view the intention behind introducing provisions of section 56(2)(viib) and to avoid undesirable consequences, CBDT has proposed to include five more valuation methods for non-resident investors, which could be methods usually used under FEMA regulations or for startups. The internationally accepted valuation methods may include different methods like valuation as per income approach (Discounted cashflow approach, relief from royalty approach, capitalized cashflow approach), market-based approach (Guideline public comparable company method, guideline transaction method) and asset/cost-based approach. It is possible that these or any other methodologies may get included under Rule 11UA for non-resident investors. It is anticipated that details of the five methods would be provided in the draft Rules.

Parameters / Considerations	Proposed Amendment	KCM Comments
Price matching guidelines	<p>'Price matching' guidelines are introduced to provide that where any consideration is received by company for issue of shares from a 'notified' non-resident entity, the price at which said equity shares are issued could be taken as FMV of equity shares for resident and non-resident investors for a period of 90 days from date of receipt of consideration from the notified non-resident entity. This will however be allowed to the extent the consideration from such FMV does not exceed aggregate consideration received from the 'notified' entity.</p> <p>Similar price matching would also be available for resident and non-resident investors with reference to investment made by Venture Capital Funds or Specified Funds.</p>	<p>While proposing this amendment, CBDT has very well acknowledged that in genuine cases, where shares are issued at price similar to issue price for notified/specified entities, provisions of section 56(2)(viib) should not be applicable. This demonstrates that the focus is allowing price that is reasonable and comparable with that of shares issued to notified entities, thereby avoiding unwanted litigation. It is anticipated that list of 'notified' non-resident entities would be provided in the draft Rules.</p>
Valuation report not older than 90 days	<p>It is also proposed that valuation report by Merchant Banker should be not older than 90 days prior to date of issue of such shares.</p>	<p>Realizing the inconvenience in obtaining multiple valuation reports at every round of funding, CBDT has thoughtfully put forward this proposal, thereby also augmenting their motto of ease of doing business in India.</p>
Safe harbour rules	<p>A safe harbour of 10% for variation in value is proposed to be provided to account for forex fluctuations, bidding processes and other economic indicators.</p>	<p>Tribunals have, in the past, accepted 10% tolerance limit while determining fair market value u/s 56(2)(viib) of the Act. It is indeed a welcome move on the part of CBDT, to bring this relaxation into law itself, which would also help in reducing undesirable litigation in this area.</p>

Parameters / Considerations	Proposed Amendment	KCM Comments
Exclusion of certain class of non-resident investors	<ul style="list-style-type: none"> - Government and Government related investors such as central banks, sovereign wealth funds, international organizations or agencies including Government controlled entities and entities where direct/indirect ownership of Government is 75% or more. - Banks or entities involved in Insurance business, which are subject to applicable regulations in the country of their incorporation or residence. - Entities having robust regulatory framework in the country of their residence: <ol style="list-style-type: none"> i. Entities registered with SEBI as Category -1 Foreign Portfolio Investors ii. Endowment Funds associated with university, hospitals, or charities. iii. Pension Funds created or established under law iv. Broad Based Pooled Investment Vehicle or Fund having more than 50 investors, not being a hedge fund or fund employing diverse or complex trading strategies. 	<p>Considering the intent of provisions of section 56(2)(viib) of the Act, investments from Non-resident investors, who are already subject to stringent regulations, according to the nature of their business-as in case of banks, insurance companies, specified funds are excluded.</p>
Start-ups	<p>It is also separately proposed to amend Notification no. SO 1131(E) dated March 5, 2019 to provide that provisions of section 56(2)(viib) shall not apply to consideration received from any person (instead of consideration from resident investor) by start-ups recognized by Department for Promotion of Industry and Internal Trade (DPIIT) as per para 4 and 5 of Notification dated February 19, 2019 issued by Ministry of Commerce and Industry.</p>	<p>This amendment is proposed to remove the anomaly created due to amendment brought in by Finance Act 2023. Notification no. SO 1131(E) only covered cases of resident investors as section 56(2)(viib) was otherwise applicable only to cases of investments from resident investors. With the amendment, section 56(2)(viib) became applicable to registered startups receiving investments from non-residents. The amendment proposed now would help remove the anomaly.</p>

It is provided that draft Rules on the above lines will be shared for public comments for ten days and would thereafter be notified.

Concluding Remarks

The provisions of section 56(2)(viib) were originally introduced to prevent generation and circulation of unaccounted money through the mode of share premium. Since inflow of funds from non-resident investors were adequately governed by FEMA regulations, non-residents were excluded from applicability of provisions of section 56(2)(viib) of the Act. With the Finance Act 2023 coming into effect, when these provisions were made applicable to non-resident investors as well, several issues arose in respect of parity between pricing guidelines as per FEMA and Income tax law. This Press Release comes as a sigh of relief for various companies from such unintended consequences, due to insertion of additional valuation methods and safe harbour rules. It would be good if the Government can also bring in clarity regarding certain grey areas around receipt of consideration for preference shares and convertible instruments. The industry is eagerly awaiting the draft Rules which will throw more light on these aspects – *hopefully the "Angels" lie in the details!*

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For further analysis and discussion, you may please reach out to us.

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