

# Tax Flash News

31 May 2023

## CBDT issues draft notification with proposed changes to Rule 11UA relating to amended angel tax provisions and notifies entities eligible for exemption from angel tax provisions

### Executive summary

Where a closely held unlisted company receives any consideration for the issue of shares from any resident exceeding the Fair Market Value (FMV) of the shares, then such excess amount is taxable under Section 56(2)(viib) of the Income-tax Act, 1961 (the Act) in the hands of the Company issuing shares (commonly referred to as 'angel tax provisions'). The Finance Act, 2023 introduced an amendment in Section 56(2)(viib) to extend such provisions to the issuance of shares to a non-resident as well.

Pursuant to the said amendment, representations were made by various stakeholders raising their concerns that non-resident investors may face undue hardship in matters related to the valuation of shares considering other valuation requirements under the Indian exchange control regulations i.e. the FEMA Regulations, Indian Companies Act, etc. and the timing of such valuations vis-à-vis the transaction date. Further, there were also recommendations to exclude shares issued to certain class of non-residents (similar to the exemption given to Category I and II AIFs / VCFs) from the purview of angel tax provisions. Based on the inputs of various stakeholders, the Central Board of Direct Taxes (CBDT) has issued a draft notification<sup>1</sup> proposing an amendment in Rule 11UA and have notified certain class of persons for exemption from angel tax provisions.

### I. Draft notification amending Rule 11UA

The changes are proposed in Rule 11UA for valuation of unquoted equity shares as under:

- On issuance of shares to non-residents, in addition to NAV and DCF methods (currently available to residents), five additional methods are proposed for the valuation of unquoted equity shares:
  - Such FMV of the unquoted equity shares can be determined by a merchant banker in accordance with any of the following methods:
    - Comparable Company Multiple Method
    - Probability Weighted Expected Return Method
    - Option Pricing Method
    - Milestone Analysis Method
    - Replacement Cost Methods
- Where any consideration is received by a Venture Capital Undertaking (VCU) for the issue of shares to a Venture Capital Fund (VCF) or a Venture Capital Company (VCC) or a specified fund, the price of the equity shares corresponding to such consideration may, at the option of VCU, be taken as the FMV of the equity shares for other resident and non-resident investors, subject to below conditions:
  - the consideration from such other resident and / or non-resident investor does not exceed the aggregate consideration that is received from a VCF or a VCC or a specified fund; *and*

<sup>1</sup> F. No. 370142/9/2023-TPL(Part-I), dated 26 May 2023

- the consideration has been received by the undertaking from the VCF or a VCC or a specified fund within a period of ninety days of the date of issue of shares which are the subject matter of valuation.
- Similar price matching benefit would be available if the issuer Company has received any consideration for the issue of unquoted equity shares from any entity notified under clause (ii) of the first proviso to Section 56(2)(viib)<sup>2</sup> (the issuance of shares to whom are exempted from Angel Tax provisions), within a period of ninety days of the date of issue of shares which are the subject matter of valuation.
- Safe harbour introduced:
  - For timing of valuation: Where the date of valuation report by the merchant banker is not more than ninety days prior to the date of issue of unquoted equity shares which are the subject matter of valuation, such date may, at the option of the assessee, be deemed to be the valuation date.
  - For the amount of fair valuation: The issue price shall be deemed as the FMV of such unquoted equity shares if the variation between the issue price and price determined with the methods provided under this rule is not more than 10%.
- The rules shall come into force from the date of publication of the notification in the Official Gazette.
- The CBDT has requested the stakeholders and the general public to provide suggestions /comments on the proposed amendments to Rule 11UA.

## II. Notified entities for exemption from angel tax provisions

The clause (ii) of the first proviso to Section 56(2)(viib) provides for exemption from angel tax provisions with respect consideration received from share issuance to entities notified by Central Government. The CBDT has notified<sup>3</sup> the following class of persons for exemption from angel tax provisions:

<sup>2</sup> Notification No. 29/2023/F. No. 370142/9/2023-TPL (Part-I)

<sup>3</sup> Notification No. 29/2023/F. No. 370142/9/2023-TPL (Part-I)

### **Shares issued to specified class of non-resident investors**

- i) Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75 per cent or more;
- ii) Banks or entities involved in insurance business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident;
- iii) Any of the following entities, which is a resident of any **country or specified territory (listed below)**, and such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident:
  - (a) Entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors;
  - (b) Endowment funds associated with a university, hospitals or charities;
  - (c) Pension funds created or established under the law of the foreign country or specified territory;
  - (d) Broad Based Pooled Investment Vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

**Specified territory or country** includes Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, United Kingdom, United States.

### **Shares issued by Start-ups to any person<sup>4</sup>**

Start-up company which fulfills the following conditions:

- a) Conditions specified in para 4 of the notification number G.S.R. 127(E), dated the 19 February 2019 issued by the Ministry of Commerce and Industry in the Department for Promotion of Industry and Internal Trade and published in the Gazette of India, Extraordinary, Part-II, section 3, Sub-Section (i) on 19 February 2019; and
- b) Files the declaration referred to in para 5 of the said notification of the Department for Promotion of Industry and Internal Trade.

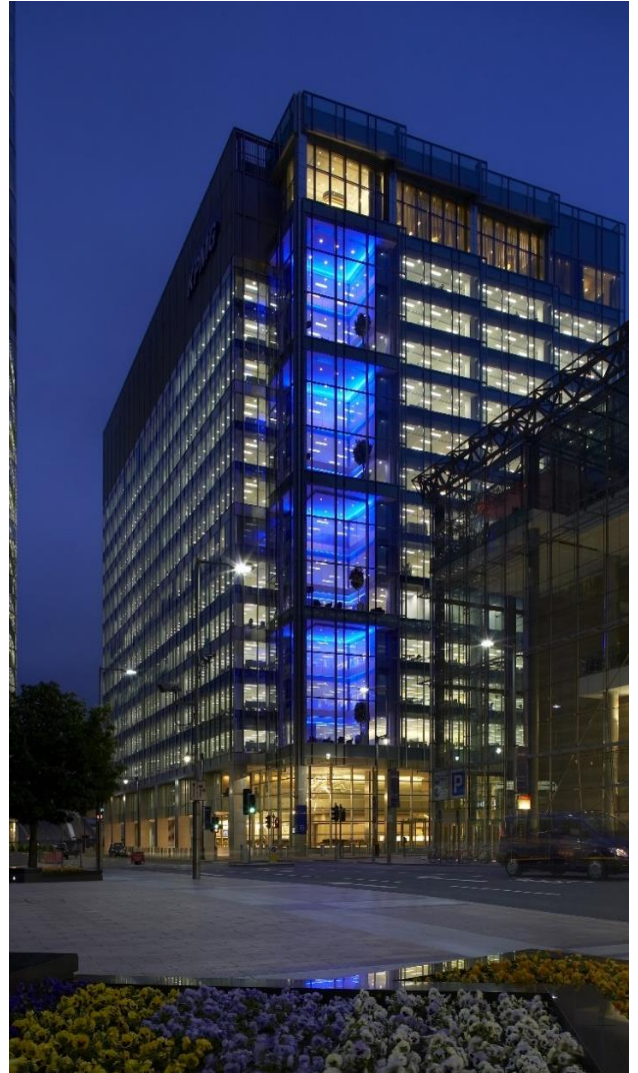
<sup>4</sup> Notification No. 30/2023/F. No. 370142/9/2023-TPL (Part-I)

## Our comments

The draft amendments to Rule 11UA are expected to provide much awaited relief to companies issuing unquoted equity shares in terms of option to use multiple pricing methods, validity of 90 days for a valuation report, safe harbour of 10% to transaction price and price matching mechanism.

It may be observed that the draft rules propose to amend only the valuation rules for unquoted equity shares and the valuation of unquoted preference shares may still be governed by erstwhile valuation rule [Sub-rule 1 of Rule 11UA – which prescribes open market valuation method]. Unquoted convertible preference shares are generally suited for private equity / VC investments in Indian companies for various commercial reasons and hence, this section of investment in Indian companies would have limited benefits from the proposed draft rules. Representations from stakeholders could be made to CBDT to explain these situations and extend the benefit of new rules to unquoted preference shares as well.

The exemption from angel tax provisions and price matching mechanism has been made available only in case where a company receives consideration from notified entities (like Category I FPIs, endowment funds, pension funds and broad-based funds) being residents of certain prescribed jurisdictions. Exclusion of countries like Singapore, Mauritius, Luxembourg, Netherlands, Gulf countries, etc. from this list, which contribute the substantial share of foreign investments in India, will limit the benefits of this notification to fewer Indian companies.



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