



# INSIGHTS



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## Angel Tax Abolition: How India's Startup Ecosystem Will Evolve

*In her Budget speech on 23 July, 2024, Union Finance Minister Nirmala Sitharaman made a landmark announcement that the Angel Tax will be abolished for all investors, effective from 1 April, 2025.<sup>1</sup> This move comes as a significant relief to the startup ecosystem, addressing long-standing demands from Venture Capitalists (VCs) and investors. In this Insight, we decided to dwell into the meaning to the Angel Tax, the Impact of Angel Tax on Indian Economy and the road ahead.*

Angel Tax refers to the taxation on the excess amount received by a startup from investors when the funding is raised at a valuation higher than the fair market value of the company's shares. This tax is primarily applied to private, unlisted companies and is levied on the discrepancy between the amount of investment and the fair market value of the equity shares issued to investors.

Introduced in 2012 by the Finance Minister Mr. Pranab Mukherjee through the Union Budget,<sup>2</sup> Angel Tax was designed to address concerns about money laundering and ensuring transparency in the investment process. The intention was to prevent startups from inflating their valuations to attract funds that could be unaccounted for.

For private companies, the Angel Tax is imposed at a rate of 30.9%,<sup>3</sup> which includes income tax, surcharge, and cess. This rate has been a source of significant financial burden for startups, potentially discouraging investment and increasing the cost of raising capital.

### **Simplification of Angel Tax:**

Angel Tax generally applies to investments made by angel investors and alternate investment funds (AIFs) when a company issue shares at a price higher than their fair market value. This excess amount, previously considered a premium, was taxed under "**Income from Other Sources**" according to Section 56(2) of the Income Tax Act.<sup>4</sup> Essentially, Angel Tax was imposed on the difference between the fair market value and the issue price of shares in private transactions.

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<sup>1</sup> Lok Sabha Budget Speech on July 23, 2024 available at: [https://www.indiabudget.gov.in/doc/budget\\_speech.pdf](https://www.indiabudget.gov.in/doc/budget_speech.pdf) (last visited on Aug. 02, 2024)

<sup>2</sup> Parliament Union Budget Speech on Mar. 16, 2012 available at: <https://www.indiabudget.gov.in/budget2012-2013/ub2012-13/bs/bs.pdf> (last visited on Aug. 02, 2024)

<sup>3</sup> Angel Tax - A Saviour for Start-Ups available at: <https://taxguru.in/income-tax/angel-tax-saviour-start-ups.html#> (last visited on Aug. 02, 2024)

<sup>4</sup> The Income-Tax Act, 1961, s. 56.



For example, if GreenTech Private Limited ("GreenTech") issues 1,000 equity shares at an issue price of INR 100 each, but the fair market value (FMV) of each share is INR 20, the shares are sold at a premium of INR 80 each (INR 100 issue price minus INR 20 FMV). This results in an excess amount of INR 80,000 (INR 80 premium per share multiplied by 1,000 shares), which is considered the income of GreenTech. Under the angel tax provisions, this excess amount of INR 80,000 was subject to taxation as it is treated as the company's income.

In contrast, if GreenTech has an FMV of INR 30 per share and the issue price per share is also INR 30, there is no income for GreenTech since the FMV is the same as the issue price. Consequently, angel tax is not applicable.

Exceptions to Angel Tax: Angel Tax, while aimed at curbing misuse of investment funds, does not apply to all scenarios. Certain entities and situations are exempt from this tax to foster a more conducive investment environment and encourage legitimate funding avenues. These exemptions are designed to support specific types of investments and entities that are deemed crucial for economic growth and stability. The following categories outline the entities and circumstances under which angel tax is not applicable:

- **Startups:** Startups that are registered with the Department for Promotion of Industry and Internal Trade (DPIIT) are exempt, provided they issue shares at a premium.
- **Government-Related Investors:** Investments made by government or government-related entities are not subject to angel tax.
- **Banks and Insurance Entities:** Banks and active entities in the insurance sector are exempt from angel tax.
- **Government-Controlled Agencies:** Agencies or entities where the government holds at least 75% ownership are exempt.
- **Category 1 Foreign Portfolio Investors:** Foreign portfolio investors classified under Category 1 and registered with the Securities and Exchange Board of India (SEBI) are not subject to angel tax.



- **Endowment Funds:** Endowment funds associated with universities, hospitals, or charitable organizations are exempt.<sup>5</sup>
- **Foreign Entities:** Indian private companies issuing shares at a premium to entities from 21 specified foreign countries—Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, the UK, and the US—are also exempt from angel tax.<sup>6</sup>

### **Impact of Angel Tax on Startups:**

The imposition of angel tax had significant consequences for the startup ecosystem in India. The tax applied indiscriminately to all investments in private companies, creating substantial barriers for startups, particularly those not registered with DPIIT. This led many startups to seek more favourable conditions abroad, where they could benefit from better tax regimes and infrastructure, thereby facilitating their growth.

Angel tax also played a crucial role in reducing foreign direct investment (**FDI**) into India. The tax's burden discouraged foreign investors, leading startups to consider relocating to jurisdictions with more favourable tax conditions. This shift was driven by the desire to avoid the high tax liabilities and complex regulatory environment imposed by the angel tax.

Additionally, startups faced challenges in defending their valuations, which were often based on projected future growth rather than current financial metrics. Tax authorities frequently deemed these valuations inflated, resulting in disputes and increased tax liabilities. This misalignment created a difficult financial environment for startups, as they had to prove the legitimacy of their valuations.

The angel tax regime forced startups to devote considerable time and resources to dealing with extensive paperwork and justifying their valuations. This diversion of focus from core

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<sup>5</sup> Aditya Singh Chandel and Suhail Bansal, "India introduces Exemptions to 'Angel Tax' to encourage Investment", AZB & Partners, June 21, 2023 available at: <https://www.azbpublishers.com/bank/india-introduces-exemptions-to-angel-tax-to-encourage-investment/> (last visited on Aug. 02, 2024)

<sup>6</sup> MINISTRY OF FINANCE, Income Tax-Notification "N No. 29/2023/F. No. 370142/9/2023-TPL (Part-I)" available at: <https://files.fintaxblog.com/wp-content/uploads/cbdt-income-tax-notification-29-2023.pdf> (last visited on Aug. 02, 2024)



business activities hindered their ability to concentrate on growth and innovation, often leading to delays in achieving key milestones or even causing business failures.

Moreover, recent amendments introduced by the Central Board of Direct Taxes (CBDT) extended angel tax to foreign investors. This expansion meant that foreign investors investing in Indian startups were also subject to angel tax, potentially further reducing foreign investment. Given that many Indian startups heavily depend on foreign funding, this could exacerbate the trend of relocating startups to more tax-friendly environments, negatively impacting the growth and development of the Indian startup ecosystem.

### **Income Tax and Angel Tax**

Section 68 and Section 56(2) of the Income Tax Act, 1961<sup>7</sup> ("Income Tax Act"), were introduced simultaneously under the heading '*Measures to Prevent Generation and Circulation of Unaccounted Money*'. While Section 68 addresses the taxation of unexplained cash credits or investments, requiring taxpayers to explain any unexplained amounts in their books, Section 56(2) deals specifically with the taxation of income from other sources, such as the excess amount received on the issuance of shares at a premium. If a satisfactory explanation is not provided, the amount is treated as income and taxed under the head "Income from Other Sources."

Under angel tax provisions, only the excess amount over the fair market value is charged, whereas Section 68 can lead to taxation of the entire amount if the taxpayer fails to justify the source of the funds.

Angel tax and Section 68 intersect in the context of startups and private companies. When startups receive investments at a valuation higher than the fair market value, the excess amount is subject to angel tax. Tax authorities often scrutinize these transactions under Section 68 to ensure the legitimacy of the investment and to prevent money laundering or tax evasion.

In the case of *SLS Energy Pvt. Ltd. vs. ITO*<sup>8</sup>, the company issued 6.8 million preference shares with a face value of INR 1 each, at a premium of INR 999 per share, raising Rs. 6.8 billion during FY 2011-12. The tax authorities challenged the premium, asserting that the company did not warrant such a premium due to a lack of substantial business activity, aside from

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<sup>7</sup> The Income-Tax Act, 1961, ss. 56, 68.

<sup>8</sup> SLS Energy (P) Ltd. v. CIT, (2024) 470 ITR 153



lending money within its group. The company argued that it was incorporated for generating and distributing electricity and had a memorandum of understanding with the Government of Madhya Pradesh for a 1320 MW Thermal Power Project. The Bombay High Court ruled in favor of the company, stating that tax authorities needed 'reason to believe' that income had escaped assessment based on credible evidence.

#### **Implications of Abolishment of Angel Tax to Startups:**

The removal of angel tax, as announced in the Union Budget 2024-25 by Finance Minister Nirmala Sitharaman, marks a significant reform for the startup ecosystem in India, bringing both positive and negative implications.

On the positive side, abolishing angel tax is expected to create a more conducive environment for investment by removing a significant regulatory hurdle. Startups will benefit from enhanced investment prospects as both domestic and foreign investors may now find Indian startups more attractive without the concern of facing additional tax liabilities. This change is likely to stimulate higher capital inflows, allowing startups to focus more on innovation and growth rather than navigating complex compliance requirements. Furthermore, the reduction in regulatory burden may decrease the incentive for startups to relocate to foreign jurisdictions in search of more favourable business conditions, thus supporting the government's policy on reverse flipping and reinforcing the domestic investment climate.

However, the removal of angel tax may also present challenges. Without this tax, there is a risk that startups might engage in practices to inflate share prices to attract higher funding, potentially leading to new forms of misuse. The shift in regulatory focus may increase scrutiny under other frameworks, such as the PMLA, which could result in more rigorous monitoring of financial transactions. Additionally, Section 68 of the Income Tax Act, which deals with unexplained cash credits, remains applicable. The absence of standardized guidelines for defining '*unexplained gains*' under this section creates potential for ambiguity and inconsistent application, posing a challenge for startups in managing their tax obligations and ensuring fair treatment.

In summary, while the abolishment of angel tax is poised to invigorate the startup ecosystem by enhancing investment opportunities and reducing regulatory burdens, it also introduces new challenges related to potential misuse and increased scrutiny under other



regulatory provisions. Balancing these aspects will be crucial to realizing the full benefits of this reform while maintaining a robust and fair regulatory framework.

### **The Road Ahead for Startups and Regulators Post-Abolishment of Angel Tax**

As India moves forward following the abolition of angel tax, the startup ecosystem stands at a pivotal juncture. The removal of this tax is expected to foster a more vibrant investment environment, encouraging both domestic and international investors to engage with Indian startups. Startups will have the opportunity to attract and deploy capital more efficiently, focusing on growth and innovation without the burden of additional tax liabilities. This reform could lead to a surge in entrepreneurial activity, with startups having greater access to resources necessary for scaling their operations and achieving their business goals.

However, the regulatory landscape will need to adapt to address the potential challenges that come with this change. The focus may shift to ensuring that the absence of angel tax does not result in unintended consequences such as inflated valuations or other forms of financial manipulation. Enhanced scrutiny under existing frameworks will be necessary to maintain financial integrity and prevent misuse. It will be essential for both startups and regulatory bodies to engage in ongoing dialogue to address any emerging issues and refine compliance practices.

Looking ahead, the effectiveness of the angel tax abolishment will depend on the development of clear guidelines and enforcement mechanisms to safeguard against potential abuses. Startups will benefit from a supportive investment climate, but they must also navigate the evolving regulatory environment with diligence. As India continues to promote its startup ecosystem, the balance between encouraging investment and ensuring regulatory governance will be crucial in sustaining long-term growth and fostering a thriving business environment.

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