

Nangia Andersen LLP

Newsflash

CBDT issues proposed changes to
Rule 11UA in Respect of Angel Tax
Provisions

June 2023





Background

The Finance Act 2023 amended Section 56(2)(viib) (also known as the “Angel Tax”) of the Income -tax Act, 1961 (‘the Act’). This amendment expands the scope of taxation under the said section to include excess consideration received by companies in which public are not substantially interested (Closely Held Company ‘CHC’) from both resident and non-resident investors. Previously, only the excess aggregate consideration received from resident investors over the fair market value of shares, when it exceeded the face value, was taxable. Now, consideration received from non-resident investors is also subject to taxation under this section

In response to the Finance Act amendment, on 19th May 2023, the CBDT (Central Board of Direct Taxes) issued a press release announcing the proposed changes in Rule 11UA of the Income Tax Rules, 1962 (‘the Rules’) regarding the valuation of shares for the purpose of section 56(2)(viib). The press release also proposed to exempt certain categories of non-resident investors from the application of section 56(2)(viib).

Subsequently, on 24th May 2023, the CBDT issued two notifications in line with the press release. The first notification identified the category of non-resident investors and some specified entities from notified countries whose investments would be exempt from the "angel tax". The second notification extended the existing exemptions granted to resident investors in startups registered with DPIIT (Department for Promotion of Industry and Internal Trade) to non-resident investors as well.

In continuation to the above CBDT has recently released proposed amendments (Draft Rules) to rule 11UA of the Rules which open for public comments until 5 June 2023, basis which the final rules shall be rolled out which shall become effective upon publication in the official gazette.

Proposed Changes to Rule 11UA of the Rules for the purpose of Section 56(2) (viib) of the Act:

Five New Valuation Methods for Non-Resident Investors

Residents Investors shall continue to apply, NAV and DCF as the valuation methods for the issue of unquoted equity shares. The same methods shall be available to Non-Resident Investors at their option. Apart from this, the proposed amended Rule 11UA provides five new valuation methods in addition to existing NAV and DCF methods for equity share investments by NR investors. The five new methods are:

- Comparable Company Multiple Method
- Probability Weighted Expected Return Method
- Option Pricing Method
- Milestone Analysis Method
- Replacement Cost Methods

Price Matching with Investment by Venture Capital and entities notified via a notification on 24th May 2023

- The price at which equity shares are issued by CHC to NR entities notified in Notification No. 29/2023 issued on 24th May 2023 shall be adopted as the FMV to benchmark equity investments by both resident and NR investors, subject to compliance with the following conditions:
 - The total consideration received from other investors at the FMV should not exceed the aggregate consideration received from the notified non-resident entity.; and
 - The consideration received by CHC from the notified non-resident entity must be within 90 days from the date of issuing the shares that are being valued.
- A price-matching facility will also be extended to investments made by venture capital funds or Specified Funds.

Proposed Changes to Rule 11UA of the Rules for the purpose of Section 56(2) (viib) of the Act:

Issuance of Merchant Banker Report within 90 days

The current Rule 11UA mandates a DCF valuation report by a merchant banker to be prepared as of the date of share issuance. In contrast, the proposed amended Rule 11UA offers flexibility by accepting valuation reports issued up to 90 days prior to the date of equity share issuance. This change applies to computing the Fair Market Value (FMV) for investments by both resident and non-resident investors.

Safe Harbor Norms

To account for forex fluctuations, bidding processes, and variations in other economic indicators, the Draft Rules propose to insert sub-rule (4) to provide a safe harbour of 10% variation in value:

- **For Resident Investors-** If the issue price for equity shares is within 10% of the price established using the NAV and DCF methods, the issue price is considered to be FMV.
- **For Non-Resident Investors-** If the issue price for equity shares is within 10% of the price calculated by NAV, DCF, or any of the five new methodologies mentioned above, the issue price is considered to be FMV.

Exclusion of certain class of persons being non-resident investors from Section 56(2)(viib) of IT Act:

- Government and government-related investors, including central banks, sovereign wealth funds, international or multilateral organizations, or agencies and entities controlled by the government or where the government holds direct or indirect ownership of 75% or more
- Banks or entities involved in the insurance business where such entities are subject to applicable regulations in the country where they are established or incorporated or is a resident;
- Any of the following entities, which is a resident of any country or specified territory, listed below, having robust regulatory framework:

- Entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors.
- Endowment Funds associated with a university, hospitals or charities.
- Pension funds created/ established under law of foreign country or specified territory
- Broad-based pooled investment vehicle or fund having more than 50 investors and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

List of 21 countries referred to above is as follows:

Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Iceland, Israel, Italy, Japan, Korea, New Zealand, Norway, Russia, Spain, Sweden, the United Kingdom and United States.



Nangia Andersen LLP's Take

The proposed draft valuation rules go a long way in providing flexibility in valuation of unlisted equity shares, thereby alleviating the incidence of Angel Tax on the Indian investee companies which receive investment from Non-Residents. Interestingly, this is the first time in the history of India, that government has laid down specific internationally accepted methods for valuation of equity shares.

It may be noted that under The Foreign Exchange Management Act ("FEMA") regulations the valuation principles for issuance of equity shares / equity instruments to non residents is permitted provided the valuation is as per Internationally Accepted Valuation Principles. However, the FEMA regulations do not detail or explain as to what are the types of internationally accepted valuation methods or principles. We believe that the methods referred in the draft rules can be used as reference for valuation of unlisted shares to non residents, even under the FEMA regulations. The harmonization of valuation rules with internationally accepted methods of valuation denote **alignment of India's tax valuation rules with global best practices in taxation and regulatory frameworks.**



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