

Angel Tax-A Raging Controversy

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Introduction

The Finance Act, 2012 added a new sub-section (viib) in section [56\(2\)](#) of the Income-tax Act, 1961 (Act) applicable prospectively from 1-4-2013. This sub section roped in it, a system of preventing the flow of illicit money, by bringing in a provision that if a Company, in which public is not substantially interested, receives share premium over and above its fair market value, as prescribed under the Act, the excess shall be exigible to tax under the head 'income from other sources', in the hands of the payee company.

The section has basically encountered those situation, wherein, the assesses indulged itself into obtaining accommodation entries in the guise of high premium. Although, the provisions of Section 68 of the Act were wide enough to cover such situations, however, owing to the interpretations laid down in certain judicial precedents, assesses were able to find an escape route from the rigors of Section 68.

Accordingly, in order to plug this deficiency of Section [68](#), the government brought an amendment into the Act, by introducing Sec 56(2)(viib). This clause, covers in it, situations where a closely held company issues shares to a resident, for a value which is in excess of the fair market value of the shares, as determinable under rule 11U/11UA of the Income Tax Rules 1962, thereby deeming it to be the income of the payee company under the head "income from other sources".

The section specifically prescribes its applicability to Residents only, hence any amount received from a non-resident, a foreign company or from a class of persons as may be notified by the Government would be outside the ambit of sec. 56(2)(viib).

Angel Tax (Start-ups) vis-à-vis Present Situation

With the rationale of ensuring that the excessive amount received as share premium does not escape taxation in the guise of accommodation entry and also, to prevent generation and circulation of unaccounted money, the objective behind introduction of this section was noble.

However, the section had a far reaching impact, adversely affecting the genuine companies as well. Even the genuine transactions were brought under the lens of revenue. As the section did not specifies any leverage for the genuineness of the transaction, but simply prescribed a blunt absolute

formula for calculation of fair market value of unquoted shares, even when the applicants have acquired share capital on account of valid and genuine transaction.

With the introduction and applicability of Sec.56(2)(viib), many start-ups started receiving income tax notices, with the authorities vouching to verify the veracity of capital infused by them. Start-ups usually had their main source of funding from the introduction of share capital. Essentially, the capital introduced in these start-ups demanded a huge premium, which was on account of the ideas, innovation or prospects, and their proposed execution by these entities. This dependency of start-ups, on equity, was also accruing to the fact that obtaining funding through loans was unattractive, mainly due to the requirement of securities and the interest rate constraints. However, since this section provided a blanket applicability to a closely held company [company in which public is not substantially interested], without laying any distinguishing factor between the genuine from the bogus, the start-ups faced a grave challenge tackling the assessing authorities with plethora of explanations and details.

In order to get the issue resolved, Start-ups prompted Commerce and Industry Ministry, which is the administrator of the Startup India initiative, to take up the matter with the Ministry of Finance and to ensure issuance of necessary instructions on section 56(2)(viib), with a specific intent to safeguard the start-ups. The moot concern expressed by these start ups had been the blind application of Sec 56(2)(viib), which could adversely impact the country's startup culture, which the Government is keen to promote and incentivize.

On the hue and cry made by the startups, the Finance Ministry clarified that no action would be taken against startups, which have been recognized by the DPIIT (Department for Promotion of Industry and Internal Trade), under the Startup India policy launched in January 2016 to build a strong eco-system for nurturing innovation and entrepreneurship in the country. In consideration of the probable difficulties that could be faced by the start-ups, the CBDT and DPIIT issued various notifications. The recent notification was issued on February 19, 2019 vide Notification No. GSR 127(E) [F. NO.5 (4)/2018-SI], wherein the limits and conditions proposed vide earlier notifications were revised. Provisions of the same are discussed in brief below

(A) Meaning of start-up for the purpose of Sec.56(2)(viib) and procedure for obtaining DPIIT's certification

An entity shall be considered as a startup:-

- (a) if it is **incorporated as a private limited company** (as defined in the Companies Act, 2013) or **registered as a partnership firm** (registered under section 59 of the Partnership Act, 1932) or a **limited liability partnership** (under the Limited Liability Partnership Act, 2008) in India
- (b) Upto ten years from the date of its incorporation/ registration;

- (c) if its **turnover** for any of the financial years since incorporation/ registration **has not exceeded One hundred crore rupees**; and
- (d) if it is **working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.**

Provided that any such entity formed by splitting up or reconstruction of a business already in existence shall not be considered a 'Startup'.

(B) Procedure for obtaining DPIIT approval

- (a) A Startup shall make an online application over the mobile app or portal set up by the DPIIT.
- (b) The application shall be accompanied by—
 - ◆ a copy of Certificate of Incorporation or Registration, as the case may be, and
 - ◆ a write-up about the nature of business highlighting how it is working towards innovation, development or improvement of products or processes or services, or its scalability in terms of employment generation or wealth creation.
- (c) The DPIIT may, after calling for such documents or information and making such enquires, as it may deem fit, —
 - ◆ recognize the eligible entity as Startup; or
 - ◆ reject the application by providing reasons.

(C) Exemption for the purpose of Section 56(2)(viib) of the Act

A Startup recognized by DPIIT shall be eligible to apply for approval, for the purposes of Section 56(2)(viib), for the shares already issued or proposed to be issued, if the following conditions are fulfilled:

- (a) aggregate amount of paid up share capital and share premium of the startup after issue or proposed issue of share, if any, does not exceed **Rupees Twenty Five Crores**
 Provided that considerations received by such startup for shares issued or proposed to be issued to a "specified company" shall also be exempt and shall not be included in computing the aggregate amount of paid up share capital and share premium of twenty five crore rupees.
 "Specified Company" means a company whose shares are frequently traded within the meaning of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and whose net worth on the last date of financial year preceding the year in which shares are issued exceeds one hundred crore rupees or turnover for the financial year preceding the year in which shares are issued exceeds two hundred fifty crore rupees.
- (b) It has not invested in any of the following assets,
 - (a) building or land appurtenant thereto, being a residential house, other than that used by the Startup for the

- purposes of renting or held by it as stock-in-trade, in the ordinary course of business;
- (b) land or building, or both, not being a residential house, other than that occupied by the Startup for its business or used by it for purposes of renting or held by it as stock-in trade, in the ordinary course of business;
 - (c) loans and advances, other than loans or advances extended in the ordinary course of business by the Startup where the lending of money is substantial part of its business;
 - (d) capital contribution made to any other entity;
 - (e) shares and securities;
 - (f) a motor vehicle, aircraft, yacht or any other mode of transport, the actual cost of which exceeds ten lakh rupees, other than that held by the Startup for the purpose of plying, hiring, leasing or as stock-in-trade, in the ordinary course of business;
 - (g) jewelry other than that held by the Startup as stock-in-trade in the ordinary course of business;
 - (h) any other asset, whether in the nature of capital asset or otherwise, of the nature specified in sub-clauses (iv) to (ix) of clause (d) of Explanation to clause (vii) of sub-section (2) of section 56 of the Act.

Provided the Startup shall not invest in any of the assets specified in sub-clauses (a) to (h) for the period of seven years from the end of the latest financial year in which shares are issued at premium;

Provided that in case the approval is requested for shares already issued by the Startup, no application shall be made if assessment order has been passed by assessing officer for the relevant financial year.

A startup fulfilling the below mentioned conditions, shall file duly signed declaration in Form 2 to DPIIT that the prescribed conditions have been fulfilled. On receipt of such declaration, the DPIIT shall forward the same to CBDT. The conditions are:-

- (a) The startup shall be recognized by DPIIT as mentioned in **Para A** above
- (b) Aggregate amount of paid up share capital and share premium of the startup after issue or proposed issue of share, if any, does not exceed, twenty five crore rupees.

For obtaining such deduction, the eligible startup has to make an application in **Form-1** along with documents specified therein, to CBDT and the CBDT may, after calling for such documents or information and making such enquires, as it may deem fit, —

- (i) grant the certificate referred to in sub-clause (c) of clause (ii) of the Explanation below sub-section (4) of section [80-IAC](#) of the Act; or
- (ii) reject the application by providing reasons.

Conclusion

In the above background, one needs to ponder upon the fact as to whether or not the startups have actually been provided relief from the draconian application of Sec.56(2)(viib). While the respective notifications have brought with it, some light of hope to the stakeholders/prospective stakeholders, however, considering the ever challenging requirements and the mechanics provided via array of DPIITs & CBDT notifications, it can be safely commented that the notifications do not come-up with much relief to the stakeholders, except for doing away with the merchant banker's valuation report requirement.

Per Contra, enhancing the limit of net worth and returned income has also looped in, some more hassles for the proposed investors. The enhanced criteria/limits might not be feasible for industry to work out, especially when the prior requirement of getting the start-up approved from Ministry is still left intact. Essentially, out of all pre-conditions, the basic condition of obtaining Inter-Ministerial Board's approval would act as the most tedious task, discouraging most of the start-ups in even planning for obtaining an angel tax exemption in future.

While the new regulations have been brought in with a huge pomp and show, however, since the regulatory framework suffers from certain lapses, the new system of exemptions from the application of Section 56(2)(viib) can very well become a reel benefit instead of accreting some real benefit.. It is time that the government should actually come out with some effective endeavor to strike out a good balance between plugging out the illicit monies in the guise of share capital and incentivizing start-ups at the same time. One of the ways for plugging the movement of illicit money could be to introduce a condition for satisfaction on the part of assessing officer to consider the genuineness of the transaction. In this way, the very intendment of the sec.56(2)(viib) can be achieved, by not just applying the section, but to consider the real intent of Law behind it.

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