Spotlight on Angel Tax

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Suppose you are a high net worth individual willing to financially support a young entrepreneur with a bright idea and incidentally you and the entrepreneur live in Singapore, you will get tax incentive in supporting her. You will be allowed to deduct the amount of investment that you make in the startup from your income and save tax. The investee company (i.e., the startup) will not be harassed by the tax authority for the price tag at which the angel fund is raised. Alternatively, suppose the same Singapore investor invests in an early stage startup in India. Still this source of funding would not attract the attention of Indian tax authorities. Now suppose, the Indian startup gets angel funding from an Indian resident. This act may bring trouble to both the investor and the beneficiary- thanks to the so called 'angel tax' in India. In India the angel investor does not get any tax credit and the startup may get a tax notice whenever it raises any subsequent round at a valuation lower than the angel round. A provision in the Income Tax Act [section 56(2)(viib)] provides that any excess consideration received by a company will be treated as 'income' in the hands of the company if it issues shares to a resident individual (and not to any entity) at a price above its fair value. Thus, if the investor is a venture capital firm, the provision will not apply and similarly it will not apply to non-resident investors. Surprised? You are not alone- the controversial angel tax has troubled may startups for the past one year. Several government agencies (e.g., the Department of Industrial Policy & Promotion, Niti Aayog), which support startup initiatives, came out openly against this activism of tax authorities. The investors and the entire startup community have urged the ministry of finance to intervene and stop this draconian 'angel tax'.

The angel tax was introduced in 2012 with a different objective- to trap shell companies for money laundering. For example, one creates a startup for software development and the startup 'sells' software to an overseas entity, controlled by the same person(s), at a low price (as it is difficult to value any intellectual property). In some cases, the domestic entity may even pass a blank CD as software. The overseas entity, in returning the favour, not only pays for the software but also invests in the equity of the startup at a hefty premium. The domestic startup thereby avoids paying tax on sale of software and this could be a fit case of money laundering. Such rogues should be nabbed and necessary actions should be taken against them. Back in 2012, it was difficult for the tax authorities to identify shell companies as they were not equipped with data analytics and hence were in the look out of external triggers to nab the wrongdoers.

The situation is completely different now- the surveillance systems of the tax authorities (e.g. CBDT) and the Ministry of Corporate Affairs (MCA) are now robust and in sync to identify money trail dynamically. Hence, one does not need angel tax to nab the money launderers.

Measurement of Angel Tax

Angel fund, as per the extant Indian Income Tax provisions, is levied when startups receive angel funding (i.e., from a wealthy individual) at a valuation higher than its 'fair market value'. The 'excess amount' (proceeds *minus* the fair value) is taxed as income at the marginal rate. Finding fair market value of a startup is a challenge and sometimes depends on several qualitative parameters and not on objective measure like cash flows. The income tax authorities have used a roundabout way to find out the 'excess' by comparing value at which the subsequent round of funding is raised. For example, if a startup raises money at a valuation of Rs. 100 per share in a particular round and thereafter raises equity at a price of Rs.90 per share in the subsequent round, the income tax authority will claim that the startup had raised the earlier round at a price which was higher than the market value by Rs. 10 per share. This is absolutely ridiculous. The lower valuation in subsequent round may happen due to many factors like, market downturn, lower-than-expected growth of the startup. It is a well-established fact that valuation is time-dependent. Immediately before the global economic recession, commodity prices were trading at hefty premium and commodity-companies were priced at higher multiples. The commodity prices plummeted after recession and those companies lost significant market value. For example, the Australian metal giant, BHP Billiton suffered a 65% decline in the profit in 2009 after metal prices and demand plunged during recession. Therefore, if one does a valuation of BHP Billiton at two time points (e.g., in 2006 and 2009), its value would be significantly lower in 2009. This does not imply that valuation in 2006 was not justified on the basis of fair market value- no one could visualise global recession in 2006 and hence the company's valuation at that time was purely based on available information.

Table 1: Startup Valuation

Business	Valuation (per share)	Valuation (per share)
Zomato	Rs. 1,36,396 (Sept 2015)	Rs. 1,13,739 (Feb 2018)
Swiggy	Rs. 24,839 (Dec 2015)	Rs. 79,834 (Feb 2018)
Bigbasket	Rs. 4380 (Oct 2015)	Rs. 6377 (Jan 2018)

Source: Private Circle Database. The figures are issue price of preference shares.

Had Zomato raised the funds in February 2018 round from angels (this was not the case as the funds were raised from institutions), they would be imposed angel tax (Table 1) for its funds raised in September 2015 on an assumed income of around Rs. 23,000 per share. However, the fact of the matter is where Swiggy was consistently growing and raising funds almost every year, Zomato fell off the radar of investors in 2016 and 2017 as it was struggling with its business model. Zomato raised money in February 2018 after a gap of almost two and half years. The lower valuation of Zomato was mainly due to investor's scepticism. The same company had later raised money in November 2018 at a valuation of over Rs. 2,18,000 per share. Therefore, the valuation of any business depends on available information at the time of the exercise and has nothing to do with what happened in the past.

Large companies take the opportunity of a buoyant stock market while deciding on the timing of initial public offers (IPOs). A private company generally floats an IPO when the market trades at higher valuations. Many of the IPOs experience significant decline in the market price post issue (Table 2). The IPOs listed in Table 2 were issued in 2018 and in a few months have witnessed non-trivial erosion in value. Wherever the decline is more than the fall in general equity market (e.g., index) that could be attributed to either overpricing at the IPO stage or poor performance of the issuer. Therefore, erosion in the market value of equity is a common phenomena and estimating overpricing of an earlier issue based on subsequent decline in price is not a justifiable measure.

Table 2: IPO Premium

Company	IPO Price per share (Rs.)	Current Market Price* (Rs.)
Ircon International	475	410
ICICI Securities	520	228.70
Bharat Dynamics	428	284.35
Garden Reach Shipbuilders	118	93.45
Indostar Capital	572	347

* As on 18 January 2019

Whenever a startup had contested the above-mentioned method for arriving at the angel tax and furnished fair valuation done by certified valuers, tax authorities did not always accept the valuation certificates of professional firms. The section 11UA (2)(b) of the Income Tax Act provides that the tax department should accept valuation done by a registered merchant bank as evidence of fair market value. Therefore, there should be no scope for confusion. One may note here that Companies Act requires that whenever a firm raises equity, its fair value should be based on a value certified by an independent person. This is to ensure that startups get to raise their funds at fair value and the investors do not force any startup, looking for fund, to accept a lower valuation. If one accepts this logic, there is no question of any angel tax as funds are raised always at fair value prevailing at that time.

The whole purpose of angel funding is to support innovation and provide necessary funding at a stage of a business when established channels of funding (including venture capital) are not available. Angels take very high risk (next only to the promoters) while funding any early stage startup and thus believe in the idea or product of the investor. Angel funding happens when the business entity is in the pre-revenue or early-revenue stage. The firm will have no cash flows or profits at this stage. In such a situation, established methods of valuation (e.g., discounted cash flows, implied price-to-sales) may not be able to capture the fair value of such a startup. One uses several other methods (e.g., scorecard, cost method, opportunity cost of efforts) and there is high degree of subjectivity in those valuations. If one smells foul in these methods and attaches motive of money laundering, that is quite unfair. Many angel funding is made through established angel networks after sincere evaluation of the prospect of the startup and all the payments happen fairly through bank with proper credit validation. Hence, chances of avoiding tax by high net worth individuals through this route are limited.

Incentivise the Investors

Rather than imposing angel tax on fledgling startups, the tax laws should incentivise the angel investors so that great ideas get essential financial support at a very stage. It will not be an exaggeration to mention that many startups would not have reached growth phase had they not got angel funding. The reputation of angels at times provides comfort to venture capital funds when the latter make investment decisions. Countries, which promote innovation, offer tax credit to angel investors (Table 3). Such tax relief provide huge incentive to the investors and thereby attract investments in early stage ventures. In order to get tax benefits, the investors should be resident individuals of the respective nations and the startups should be the 'qualifying' ones. While in Singapore, the tax benefit is in terms of setoff facility from regular income, the benefit in the United Kingdom is even better. Rules provide income tax as well as capital gain relief. Tax on income in the USA is a state subject and hence angel investor tax credit programmes vary from one state to another. States, known for startup culture, have generous tax incentive programmes.

Table 3: Tax Credit to Angel Investors

Country	Tax Benefit
Singapore	Angel Investors Tax Deduction (AITD) Scheme is available to angel investors till 2020. An approved angel investor who invests a minimum of S$100,000 in qualifying startups is eligible to claim tax deductions for the 50% of investments made for each assessment year up to a period of two years with a maximum cap of S$500,000. The amount may be deducted from the individual's total taxable income. The angel investor must hold the investments for a continuous period of two years to claim tax credit.
United Kingdom	Under the Enterprise Investment Scheme (EIS), angel investment in the equity of a qualified startup can get income tax relief of up to £ 300,000 per year. Plus, the angel may also get capital gain tax relief on disposal of EIS shares after three years of holding period. If EIS shares are disposed at a loss at any time (after the mandatory three year holding period), the loss can be offset against income (and not capital gains) of the investor in the year of loss. EIS is for early growth stage startups. There is a separate tax incentive scheme for early stage startup, called the Seed Enterprise Investment Scheme (SEIS). Under SEIS, angel investors get tax relief of up to 50% of investment value, subject to a maximum relief of £100,000 per year. Further, investors can also benefit from up to 50% Capital Gains Tax relief (up to a maximum of £50,000) on gains, which are reinvested in EIS eligible shares.
Massachusetts (United States)	Effective from 2017, angel investors get tax credit for investments in qualified business (based in Massachusetts) up to 20% of investment value, subject to a total tax credit of $50,000 per year.

Conclusions

In May 2018, the income tax department has clarified, through a notification, that section 56(2)(viib) will not apply to certain sections of the startups. The income tax authorities claim that startups registered with the DIPP will enjoy such exemption. However, recent newspaper reports suggest that even DIPP-approved startups were not spared from the angel tax threat. Following the global practices, it is required that startups are not harassed with the angel tax and the exemption from angel tax should be extended to all startups, approved or not. Only criteria could be that the startup should be a registered unlisted company with some size restrictions. Further, in order to attract more angel funds, angel investments should be eligible for tax credits. In order to ensure that such tax concessions are not misused, eligibility criteria may be laid down for both the investors and the investee. The May 2018 notification of the Central Board of Direct Taxes (CBDT) providing angel investors a tax status at par with the Venture capital funds is not enough. What is required for angel investors is not equal status with venture capital funds, but tax credit for investments made. There is a high expectation from the Hon'ble Finance Minister on 1 February when he presents the budget. Hopefully, the controversy with the angel tax will be put to rest for good.