



ERGO

Analysing developments impacting business

BREATHER TO START-UPS FACING ANGEL TAX PROCEEDINGS

14 August 2019

The Central Board of Direct Taxes – the apex body for direct tax administration in India (CBDT), has issued a clarification dated 9 August 2019 (Clarification) that provides further clarity with respect to ‘angel tax’ levied on start-ups. Further, as per a recent circular (dated 7 August 2019), the CBDT has announced simplification of tax assessment of start-ups in cases where angel tax levy is the subject matter of the proceedings.

Background

As per Section 56(2)(viib) of the Income-tax Act, 1961 (IT Act), issuance of shares by a closely held company to a resident at a premium to fair market value (FMV) of the shares (determined in the prescribed manner) results in such premium being taxed as ordinary income in the hands of the issuer company. This tax levy is commonly referred to as ‘angel tax’.

The Department for Promotion of Industry and Internal Trade (DPIIT) had issued a notification in February 2019 as per which the criteria applicable to an eligible start-up and the conditions to be fulfilled for claiming certain income-tax benefits (including exemption from angel tax) were relaxed (DPIIT Notification). Following this and keeping with the past trend, the CBDT had issued a notification in March 2019 to provide that angel tax will not be applicable to start-ups recognised by the DPIIT. Our [Ergo](#) analysed that development.

Notably, the DPIIT Notification explicitly provided that the angel tax related relaxation provided therein would not be available with respect to those share issuances for which addition on account of angel tax was already made prior to 19 February 2019 (being the date of DPIIT Notification). This was seemingly unfair to those start-ups which, despite satisfying all other conditions, could not benefit from this relaxation solely because an adverse order was passed by the tax authorities prior to 19 February 2019.

Clarification

To address this concern, the CBDT has relaxed the aforesaid condition and extended the benefit of the DPIIT Notification to even those start-ups where addition on account of angel tax had already been made prior to 19 February 2019 (provided the other conditions mentioned in the DPIIT Notification are fulfilled).

Comments

The tax authorities' approach towards angel tax related scrutiny has caused genuine hardship to corporates receiving funding and the valuations are being increasingly challenged. The government is trying to salvage the situation.

The Hon'ble Finance Minister in her recent Budget speech did talk about resolving the angel tax issue for start-ups and the aforesaid announcements are in addition to the recently introduced amendments whereby:

- primary share issuances by a venture capital undertaking to a Category II Alternative Investment Fund shall be exempt from angel tax – *prior to the amendment, this exemption was available only to share issuances to a venture capital fund (a sub-category of Category I Alternate Investment Fund)*; and
- failure to comply with the conditions specified in the DPIIT Notification will trigger angel tax in the year in which such failure takes place – *this seeks to ensure compliance with the prescribed conditions and provide clarity as to the consequences of non-compliance.*

Measures like these are welcome and are steps in the right direction for (i) making it easier for start-ups to do business; (ii) reducing unwarranted tax litigation and hardship; and (iii) giving a further fillip to the start-up community. One hopes that the rigour of angel tax scrutiny is eased in case of entities other than recognised start-ups also which have a robust valuation back up.

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