Playbook for Handling Angel Tax and Section 68 Tax Notices

3ONE4 CAPITAL

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Background & Origins

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Angel Tax

"Angel Tax" or Section 56(2)(viib) is an anti-abuse measure introduced in 2012 as a means of "preventing the generation and circulation of unaccounted funds".

The Section states that if:

- A private limited company
- Issues shares at a premium (i.e., above its face value)
- Which exceeds the fair market value (FMV) of the shares
- The difference between the issue price and the FMV will be subject to tax as "Income from Other Sources"

Why was Angel Tax introduced?

It was introduced due to a 2009 instance of alleged money-laundering wherein large sums of money were invested into an unlisted company at a massive premium. The case has been subject to litigation since 2009, leading the introduction of this section in 2012.

Who pays Angel Tax?

The private limited company pays Angel Tax, not the investors.

Are there any investors whose investment is exempt from Angel Tax?

Yes, two kinds of investors are exempt from the application of this section:

- Investments by SEBI/IFSCA registered Category I and Category II AIFs
- Certain investors who are notified by the Tax Department

What are the valuation methodologies for validating the FMV of the securities?

Rule 11UA(2) of the Income Tax Rules, 1962 prescribes 2 valuation methodologies for establishing the FMV of the shares:

Net Asset Value & Discounted Free Cash Flow method

There are other valuation methodologies that are expected to be announced for establishing the FMV.

If I have a valid valuation report, can Angel Tax still apply?

Yes, it may still apply. A valid valuation report is one that is accepted by the Assessing Officer (AO or taxman). Section 56(2)(viib) uses the phrase “to the satisfaction of the Assessing Officer”, thus giving the AO significant discretionary powers to accept the valuation report or reject it.

How would the taxman dismiss the valuation report?

It is usually based on the difference between performance and projections. There have been occasions when the difference between the actual performance of the Company and the projections used in the valuation report is used as a justification to say that the valuation report does not reflect the FMV of the shares.

Is a high share premium an indication of any wrongdoing?

No. A high share premium can be the consequence of perfectly valid, legal, commercial decisions taken by the Company.

A high share premium is the result of 3 factors, all of which are individually valid business decisions taken by a company:

Valuation | Low share base | Low face or par value

If one were to take the example of 2 companies with the same valuation but different outstanding shares:

	COMPANY A	COMPANY B
Valuation (A)	₹ 30,00,00,000	₹ 30,00,00,000
Outstanding Shares (B)	50,000	5,00,000
Face Value (C)	₹ 1	₹ 1
Issue Price (D) = (A/B)	₹ 6,000	₹ 600
Share Premium (D – C)	₹ 5,999	₹ 599

An increase in any of the factors, viz, valuation, outstanding shares or face value, creates a massive difference in the share premium, showing how a high share premium is not an indicator of unaccounted funds.

Companies Act, 2013 does not prescribe a minimum paid-up capital for a private company. As such, entrepreneurs can start a business with any amount and raise funds from investors for scale.

What is the tax rate applicable for Angel Tax?

The tax rate for Angel Tax is the same as the tax rate for other income generated by the Company, i.e., the corporate tax rate.

Section 68

Section 68 is an anti-abuse measure which serves as a means of "preventing the generation and circulation of unaccounted funds".

If any money received by a person for which said person doesn't offer a valid explanation about the nature or source of the funds, to the satisfaction of the taxman, such amount can be liable to tax as per this section.

Is it linked to Angel Tax?

Since 2012, this section has been amended to link it to the issuance of shares by a private company, including issue of shares at a premium. This links it to Section 56(2)(viib) – Angel Tax.

What sort of explanation does Section 68 entail?

The person who has invested in the Company needs to offer an explanation about the nature and source of the money they have invested in the Company. This has to be to the satisfaction of the taxman.

What if the taxman is not satisfied by the response?

Then the money so invested can be liable to tax.

Who pays the tax?

The Company pays the tax.

Are any investors exempt from Section 68 related to the issuance of shares?

Yes, 2 kinds of investors are exempt:

- SEBI/IFSCA registered funds
- Non-residents

What is the tax rate applicable for Section 68?

Section 68 has a flat tax rate of 60%, with a surcharge of 25% and a cess of 4%. The total tax rate is around 78%. Penalties may also apply.

What are the Chances of Getting A notice & How To Prepare for One?

What are the chances of getting a notice & how to prepare for one?

How are notices sent by the Tax Department?

The Tax Department uses a system known as Computer-Aided Selection of Cases For Scrutiny (CASS) for selecting cases for scrutiny. As per the Tax Department, "CASS is a system-based method for scrutiny selection which identifies the cases through data-analytics and three-hundred sixty-degree data profiling of taxpayers and in a non-discretionary manner." (link)

What are the chances that my company may get picked up for scrutiny under CASS for Angel Tax or Section 68?

As CASS is a computer-based system, the following may be criteria it employs for selecting cases:

- Has the Company issued shares at a premium?
- Is the amount raised by the Company substantial?
- Is the Company loss-making?

Basis discussions with experts as well as companies who have received such notices, these seem to be the common criteria for selection. Other criteria would also apply.

If your company meets the aforementioned criteria, you may end up getting such a notice. It's best to prepare for the same.

As a Founder, how can I prepare for such a tax notice?

1. Assume that you will recieve an Angel Tax and/or Section 68 notice during your journey as a founder
2. Run basic diligence on your investor to ensure that no ill-gotten gains are being invested into your company. Both Angel Tax and Section 68 are about the bonafides of the investor as much as they are about the company. Run reference checks where possible
3. Inform your investors of this eventuality and apprise them of the information they may need to give you
4. Collect the following information about your investors at the very onset:
    - Full Name
    - PAN
    - Address
    - Contact Details
    - Willingness to provide details to the Tax Department in case such a notice comes
5. Get referred to a good Chartered Accountant/Tax advisor who has dealt with such cases in the past
6. Upon closure of a fundraise, prepare a docket on a yearly basis containing responses to such notices

What to Expect in the Notice?

What to expect in the notice?

What are the section numbers under which I can receive a notice?

The Tax Notices are normally issued under Section 142 of the Income Tax Act, 1961 – specifically Section 142(1).

What happens if the Tax Notice I received does not mention Section 56(2)(viib) or Section 68?

As the Tax Notices are a request for information before the taxman can take action, if any, they may not mention Section 56(2)(viib) or Section 68.

How do I know if a notice is for Section 56(2)(viib) or Section 68?

The data requests and phraseology cast a light on which sections may be invoked.

- Section 68: Any matter related to “creditworthiness” or “bonafides” of the investors
- Section 56(2)(viib): Any matter related to “high share premium”, “valuation”, etc

What are the most common questions in the Tax Notice?

The most common questions and data requests in the notice will include:

Details of investors to establish their creditworthiness. This includes:

- Last 3 years tax returns
- Last 3 years bank statements
- Last 3 years financials

Details regarding the justification of the high share premium for the securities issued by the Company. This includes:

- Valuation report for the issuance of securities at a premium
- Audited financials of the Company during and post the fundraise

Do you have examples of such Tax Notices?

1. The following accounts or documents or information is/are sought under section 142(1) of the Income-tax Act, 1961:

Your case is selected for complete scrutiny under CASS for the year under consideration reasons specified in the selection as :

1. **Large share premium received during the year (verify applicability of Sec 56(2)(viib) or any other relevant**

3.Inflow of funds in an entity consistently showing loss before depreciation

1. With respect to 1) With respect to shRE PREMIUM during the year under consideration, kindly submit the below specified details:
a) Name and address of the shareholders.
b) PAN of the shareholders.
c) Face Value and premium on each share.
d) Number of shares allotted to each shareholder.
e) Total value of the shares allotted to each shareholder.
f) Payment received from each shareholder during the financial year.

2) Provide documentary evidence to substantiate the identity and ITR of last 3 years of shareholders to substantiate creditworthiness the shareholders as well as the proof of genuineness of transaction in respect of fresh credit of the share capital/premium account.
3) The valuation report with respect to the working of EPS and justification for the quantum of premium.
4) The comparison of the working of EPS and share premium with the immediately prior instance, wherein the shares were allotted with premium.
5) The year wise details of dividend declared during the year and three earlier years.

6. With respect to the fresh issue of share during the year under consideration, kindly submit the below specified details:

a) Name and address of the shareholders.

b) PAN of the shareholders.

c) Face Value and premium on each share.

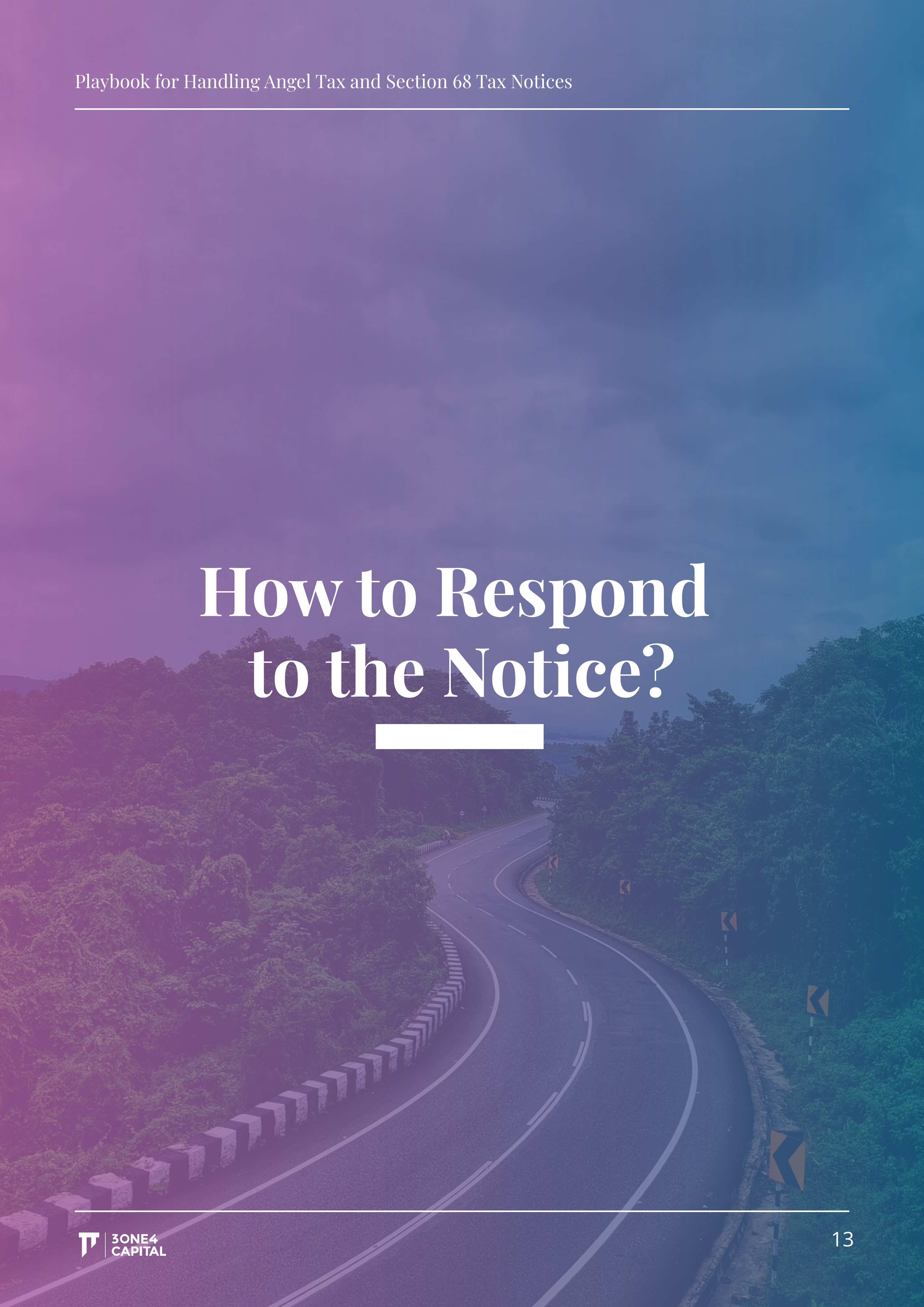
d) Number of shares allotted to each shareholder.

e) Total value of the shares allotted to each shareholder.

f) Payment received from each shareholder during the financial year.

7. Provide documentary evidence to substantiate the identity and ITR of last 3 years of shareholders to substantiate creditworthiness the shareholders as well as the proof of genuineness of transaction in respect of fresh credit of the share capital/premium account.

8. The valuation report with respect to the working of EPS and justification for the quantum of premium.



How to Respond to the Notice?

How to respond to the notice?

How should one react to such a notice?

First and foremost, relax.

Such notices are computer driven basis hard-coded rules. These have become routine in nature and should be looked upon as such. Do not panic.

What should one do after receiving such a notice?

- First, reach out to a CA/Tax Advisor who has worked on this before. Time is of the essence
- Inform your investors of such a notice and ask them for the information required in the Tax Notice
- Collate all the information required in the notice
- Respond to all the queries on time – even if the response is that the Company was unable to secure the information, note it down in writing

Should I attempt to respond to this by myself?

It would not be advisable.

A Tax Notice is complicated, with nuances and intricacies best understood by experienced professionals. Their expertise arises from understanding the issue and how to respond to such notices. Any misstep can lead to prolonged litigation and loss of time, capital and resources.

What happens if my investors do not want to give confidential information such as their bank statements and tax returns?

This is understandable.

The taxman has powers under Section 133(6) of the Income Tax Act, 1961 to directly seek such information from any taxpayer.

1. Make attempts to ask your investors for such data.

2. If they refuse to provide it, ask them for a letter which should state the following:

- Name, contact details and PAN of the Investor
- That the investor has invested in the Company
- Details of the investment (number of securities, face value and share premium)
- The Company has asked for sensitive information such as tax returns, bank statements, etc
- Owing to the sensitive nature of the information, the Investor is not inclined to share the same with the Company
- However, the investor is willing to share the same with the Tax Department in a secure, confidential manner if the Tax Department sends a request for the same
- That the investor shall fully co-operate with the Tax Department

3. Collate responses and send it to the Tax Department on time. Even an email or letter from the investors should work. Speak with your tax advisor on this.

What will happen if there is a large difference between my projections in the valuation report and my actual performance? Will Angel Tax automatically apply?

No plan ever survives a clash with reality.

The assumption that a Company can execute exactly as per plan is erroneous. Angel Tax is an anti-abuse measure, not a tax harvesting section. As such, the Company would need to justify the following:

1. How it achieved such a high valuation?
    - Details about the founding team, the technology, the type of business, founder pedigree, etc

2. Who did the Company raise capital from?
    - Details of the investors, such as:
        - Their pedigree
        - News articles about them
        - Other distinguishing details

3. Why is there a difference between the performance and projections used in the valuation report?
    - Explain this in simple terms speaking about the effort put into the business and why they may have not yielded the kind of results as expected
    - This can include:
        - Macro issues
        - Issues with the market sizing
        - Competition
        - Any other business factors
    - Rely on the reporting done to your investors on this as supporting evidence

What will happen if I do not respond to the notice or don't give adequate information?

The Company must respond to the notice with all the information it has on hand and make efforts to obtain any other information sought. Failure to do this may result in a tax demand notice and lead to litigation. The Company must demonstrate to the taxman that it is cooperating in this scrutiny.

The Tax Department has an important and often thankless job to do. The support of citizens is needed to ensure that they can discharge this duty.

If the scrutiny is passed successfully, does that mean I won't get another in the future?

No. Each assessment year is distinct and separate from the others. So long as CASS has these hard-coded rules, there may be a chance that another such notice is issued to you.

Any other mitigants to keep in mind?

- Register with DPIIT as a startup under Startup India. Such DPIIT recognized Startups have a special dispensation during such matters

- Try not to have a very large share premium. Ways to reduce them include:
    - Increasing the face value of the securities to reduce the share premium. Share premium is the difference between the issue price and the face value, so a higher face value would result in a lower share premium
    - Try to issue bonus shares from the past share premium. This will increase the number of outstanding securities, which can help reduce the share premium during future fundraises

- Raise from bonafide investors and let them know to expect such notices in the future. Treating this as a routine part of running a startup can help contextualize this and reduce the shock of receiving such a notice in the future

Is there anything I can do to prevent this from happening in the ecosystem?

Yes. There are plenty of organizations that have been writing on this issue and seeking safeguards to ensure that genuine startups do not face this issue. Seek them out and contribute to such efforts. It will take time and effort to get the right balance and for this, all the pieces matter.

DISCLAIMER

This playbook has been prepared as a reference guide only and does not constitute legal and/or professional advice/opinion/guidance. Companies and Founders should use this as a guide to obtain a basic understanding of the issues. It is strongly advised to discuss any action with experts and advisers before undertaking any action on this matter. The author of the document disclaims any liability and/or damages incurred by any party due to their (mis)use of the content of this playbook. Contexts may differ from case to case.

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