A Look At The Regulatory Provisions Related To The Angel Tax

Section 56(2)(vii b) of the Income Tax Act

Provisions of Section 56(2)(vii b) of the Income tax were introduced vide Finance Act 2012. As per this and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely:—

(vii b) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Exceptions to Section 56(2)(vii b)

The section excludes certain notified sectors or entities and venture capital funds i.e. the provisions of this section shall not apply in cases where the e consideration for issue of shares is received—

(i) by a venture capital undertaking from a venture capital company or a venture capital fund; or

(ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.

Explanation.—For the purposes of this clause,—

(a) the fair market value of the shares shall be the value—

(i) as may be determined in accordance with such method as may be prescribed; or

(ii) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, whichever is higher;

(b) "venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (a), clause (b) and clause (c) of 17[Explanation] to clause (23FB) of section 10;]

Subsequent DIPP notifications and clarifications on tax exemption to Startups

- **Notification no G.S.R. 501 (E). dated 23rd May 2017**[1]

  This notification stated that if a Startup were to seek or apply for income tax exceptions under the Startup India Action Plan including but not limited to the sec 56(2) (vii b) exemption; it required to be:

  a. an entity incorporated on or after the 1st day of April, 2016 but before the 1st day of April, 2019,

  b. had to work towards innovation, of products or processes or services, should be a scalable business model with a high potential of employment generation or wealth creation, and

1 DIPP notification no G.S.R. 501 (E). dated 23rd May 2017

c. obtain a certificate of an eligible business from the Inter-Ministerial Board of Certification as constituted by Department of Industrial Policy and Promotion from time to time. Undifferentiated products or services or processes with no or limited incremental value for customers or workflow would not make a Startup eligible for tax benefits.

- **Notification no G.S.R. 364(E), dated 11th April 2018 in supersession of the above notification**[2]

This notification stated that a startup was eligible to apply for exemption under section 56(2)(vii b) if the following conditions were fulfilled: —

(i) the aggregate amount of paid up share capital and share premium of the startup after the proposed issue of shares did not exceed ten crore rupees,

(ii) the investor/ proposed investor, who proposed to subscribe to the issue of shares of the startup (hereinafter in this notification referred to as "investor") had, —

a. the average returned income of twenty five lakh rupees or more for the preceding three financial years; or

b. the net worth of two crore rupees or more as on the last date of the preceding financial year, and

(iii) the startup had obtained a report from a merchant banker specifying the fair market value of shares in accordance with Rule 11UA of the Income-tax Rules, 1962.

- **Notification no G.S.R. 34(E)J dated 16th January 2019 in partial modification of the above notification**[3]

In the last quarter of 2018 several startups recipients of foreign and Indian capital were thronged by income tax notices. As a reaction to the industry uproar, the latest DIPP notification was issued with partial modifications which frankly don't change too much. It was clearly more to appease the Startup Community and I find out no real outcome or solution except that the DIPP, rather than the startup itself now will make the recommendations to the Income tax department basis applications made to them to qualify for the tax exemption

The notification states that a Startup recognised by DIPP shall be eligible to apply for approval for exemption from section 56(2)(vii b) of Income tax for the shares already issued or proposed to be issued if the following conditions are fulfilled—

(i) aggregate amount of paid up share capital and share premium of the startup after the proposed issue of share, if any, does not exceed ten crore rupees;

(ii) The investor/ proposed investor shall have

a.a. returned income of Rs.50 lakh or more for the financial year preceding the year of investment/proposed investment; and

2 DIPP notification no G.S.R. 364(E), dated 11th April 2018

3 DIPP notification no G.S.R. 34(E)J dated 16th January 2019

a.b. net worth exceeding Rs.2 crore or the amount of investment made/proposed to be made in the startup, whichever is higher, as on the last date of the financial year preceding the year of investment/proposed investment.

The notification also states that an application for approval under this para shall be made to DIPP and shall be accompanied by the documents specified therein: and that the application of the recognised startup shall be transmitted by DIPP to CBDT with the necessary documents. The CBDT, within a period of 45 days from the date of receipt of application from DIPP may grant approval to the Startup for the purposes of exemption from section 56(2)(vii b) of the Income tax Act or decline to grant such approval.