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ANGEL TAX ON NON-RESIDENTS: DEVILISH ACT ON STARTUPS?

Ribhava Raj

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ANGEL TAX ON NON-RESIDENTS: DEVILISH ACT ON STARTUPS?

Ribhava Raj[*]

[***Abstract:*** *Angel Tax, originally conceived to curb fiscal misuse in unlisted companies and startups, its range has now broadened to include investments from non-resident Indians and overseas investors. This shift in policy has sparked intense discussion about its consequences on startup ecosystems and the balance between fostering foreign investments and tackling money laundering. This article meticulously dissects the historical roots of Angel Tax, explores the intricacies of company residency determination, and delves into the controversial Place of Effective Management (PoEM) test. The introduction of this test, albeit intended to thwart tax evasion, introduced ambiguity and potential adverse consequences. The impact is not just confined to taxation; it extends to reshaping the investment landscape for startups.*

The recent amendment in the Finance Act of 2023 extended the reach of Angel Tax to non-resident investors, triggering concerns about its influence on startup funding. This has resulted in a significant decline in funding for Indian startups, jeopardizing their growth and potential. The implications of this amendment not only affect the economic landscape but also pose a threat to employment opportunities, potentially compelling startups to seek more tax-friendly jurisdictions. While certain exemptions exist, including a threshold for tax exemption and exclusions for specific types of investors, the broader consequences remain a cause for apprehension. The government's decision to extend Angel Tax to non-resident investors reflects a focus on curbing black money, yet it risks impeding economic growth and the flourishing startup ecosystem, especially with the potential exodus of startups to more tax-friendly destinations.]

I

Introduction

In the ever-evolving landscape of India's taxation system, the term "Angel Tax" has become a focal point of discussion, debate, and concern. Angel Tax, colloquially known as Section 56(2)-(viii) of the Income Tax Act, 1961, has been a subject of both controversy and

[*] Mr. Ribhava Raj is a Fourth Year B.A. LL.B. (Hons.) Student at Chanakya National Law University, Patna. Email: ribhav.cnlu@gmail.com

contention since its inception in 2012. Initially designed, to curb the misuse of funds and deter tax evasion, it targeted unlisted companies, particularly startups, receiving investments from resident Indians. Yet, recent advancements have broadened its scope to encompass investments from non-resident Indians and overseas investors, marking a significant shift in India's tax policy.

As we delve into the intricate facets of Angel Tax, this paper aims to unravel its historical origins, the rationale behind its introduction, and the ripple effects of its recent amendments. From the nuances of determining a company's residence to the complex Place of Effective Management (PoEM) test, this paper will examine how these tax regulations impact startups in the country. Furthermore, this paper tries to analyze the delicate balance between encouraging foreign investment in the startup ecosystem and combatting money laundering, which has become a pivotal challenge for Indian policymakers.

II

Residency & Taxation

Resident company relates to an entity's tax residence. Residence in India finds its mention in Section 6 of the Income Tax Act, 1961. Only those entities are subjected to tax which are the residents of the jurisdiction imposing tax. Section 6 talks of residence in the context of both individuals and companies. An individual is considered a resident if he resided in India for 182 days or more in the previous year, either continuously or intermittently would be considered as resident.[1] Alternatively, a firm or an association of persons is regarded as resident in all cases unless they prove that the control and management of their affairs is situated wholly outside India.

To determine a company's residence, different jurisdictions apply their measures. These measures vary from simple, objective requirements such as their place of incorporation and central management, as seen in the UK[2], if the company has a registered office or a place of

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1 Income Tax Act, 1961, S. 6(1).

2 PwC, https://taxsummaries.PwC.com/united-kingdom/corporate/corporate-residence.

management situated in the jurisdiction, as is seen in Germany[3] to more complicated systems, like the necessity of a Place of Effective Management ("PoEM") at the greater part of the year, as is seen in Italy[4].

For a long time, India had fairly simple modus to assess a company's residence, through its place of incorporation. For assessing foreign companies, it was seen if control and management of the company's affairs were "wholly" situated in India during the concerned financial year.[5] This was known as the “control and management test”.

III

Poem Test

However, the inclusion of the term “wholly” made way for various resident companies to circumvent the Indian tax authorities by establishing a major part of their management in India and then taking an insignificant management decision in any other country. To deal with this loophole, the Direct Taxes Code Bill of 2010 proposed the test of PoEM to assess non-resident companies[6]. The poem is an internationally recognized test to assess a company's residency for tax purposes. Place of Effective Management refers to a location where the key management, and commercial decisions essential for conducting the business of an entity as a whole are effectively made.[7] Thus, even if some minor decisions for running the company's affairs were being taken outside India, but the key management and commercial decisions were being taken in India, then that company would be deemed as a resident and taxed under Indian law.

But this provision came with a twist. An expression, “any time in the year” was added to PoEM under Section 4 (b). This inclusion not only created ambiguity concerning the assessment of taxes but also came with far-reaching adverse implications. For instance, it implies that even if key managerial personnel of a non-resident company while

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[3] PwC, https://taxsummaries.PwC.com/germany/corporate/corporate-residence.

[4] PwC, https://taxsummaries.PwC.com/italy/corporate/corporate-residence.

[5] PwC, https://taxsummaries.PwC.com/india/corporate/corporate-residence.

[6] Direct Taxes Code, 2010, S. 4.

[7] PwC, https://taxsummaries.PwC.com/india/corporate/corporate-residence.

vacationing in India, took any decision essential for running his company's business as a whole, then the global income of such company would be liable to be taxed under Indian laws.
This kind of provision was to be nowhere found in the world, except in Malaysia[8]. The provision was naturally met with protests from all over the market. The Government therefore replaced the expression, “any time in the year” with “in that year”, through the Finance Act of 2015[9]. The explanation to Section 6(3) defines PoEM as "a place where critical management and commercial decisions essential for conducting the business of an entity as a whole are effectively made."

IV

Active & Passive Companies

To further clear the ambiguities concerning the 2015 amendment, the Government brought an additional requirement for fulfilling the PoEM test. Foreign companies are now classified as Active Foreign Companies and Passive Foreign Companies. A foreign company qualifies as an active foreign company when it meets the following criteria[10]:

1. Passive income constitutes below 50% of its overall income. Passive income encompasses earnings from transactions involving both the buying and selling of goods involve related parties. Additionally, it includes income generated from sources such as royalties, dividends, capital gains, interest, and rent.
2. India hosts less than 50% of the company’s total assets.
3. Fewer than 50% of the company's workforce consists of Indian residents. This workforce includes individuals who perform duties akin to those undertaken by employees, even if they are not employed directly by the corporation.

[8] PwC,https://taxsummaries.PwC.com/malaysia/corporate/corporate-residence#:~:text=Generally%2C%20a%20company%20is%20regarded,and%20control%20of%20the%20company.

[9] Finance Act, 2015, S. 4(3).

[10] Income Tax Department, Ministry of Finance, Government of India, https://incometaxindia.gov.in/pages/i-am/foreigncompany.aspx#:~:text=The%20guidelines%20prescribe%20that%20a,assets%2C%20employees%20and%20payroll%20expenses.

4. The payroll expenses incurred for Indian resident employees amount to below 50% of the company's total payroll expenses.

Should a company fail to satisfy any of these conditions, it is deemed a passive foreign company. Only passive foreign companies who have POEM in the previous financial year are subject to tax on their global income.

While the introduction of the PoEM test may still be regarded as an unfair test because it seeks to impose double taxation on the same income (one imposed in the place of incorporation of the resident company and the other in India), it should be noted that the determination of PoEM is a yearly exercise, and thus passive foreign companies may restructure their assets in such manner that prevents them from being classified as a passive company.

V

Double Taxation Avoidance Agreements

Companies can also take benefit from jurisdictions that have Double Taxation Avoidance Agreements ("DTAA") with India and accordingly incorporate them at such places. A question then arises; in a place of conflict between the IT Act, 1961 and a DTAA, which shall prevail? Section 90(2) of the IT Act, 1961 answers this question favoring the assessee. According to it, where there is a DTAA, about the assessee, the provisions of IT Act, 1961 shall apply to the extent beneficial to that assessee.[11] This implies that if a DTAA is more favorable to the assessee then IT Act, 1961 shall not apply. This aligns with Article 51 of the Constitution. Up until June 2023, India has signed DTAAs with 94 countries.[12]

Aside from the risk of falling prey to double taxation, non-resident companies enjoyed a major advantage over their domestic counterparts. They were exempted from the Angel Tax. However, with the start of the financial year 2023-24, a seismic shift is to be observed in India's tax landscape, which has extended the reach of Angel Tax beyond resident investors.

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[11] Income Tax Act, 1961, S. 90(2).

[12] PwC, https://taxsummaries.PwC.com/india/individual/foreign-tax-relief-and-tax-treaties.

VI

Overview & Impact of Angel Tax

The Finance Act, of 2023 has changed rules and regulations concerning investment in startups. A modification has been implemented regarding Angel Tax. Now unlisted entities such as startups will have to pay Angel Tax if they raise money from non-resident investors.[13] Before this only resident investment used to be considered for Angel tax. There will be an impact concerning investment in the start-ups which are already tumbling under pressure.

Angel Tax was introduced in 2012 to make those pay who circumvent the logical and legal process of paying taxes and of course, who want to park their black money in startups or a shell company they are paying for it to be a start-up. To understand Angel Tax, we first have to understand who is an angel investor.

An "angel investor" is a wealthy individual who offers funding for a business startup.[14] Suppose you have an immense amount of money and there is a start-up that needs money or capital so you go through their business and then invest in it, then you'll be called the angel investor. Angel investors usually infuse their capital in exchange for convertible debt or ownership equity of the company.

So, what is an Angel Tax? Earlier when investment in startup was raised from the resident sources it was counted as Angel Tax, but now non-residents shall also be included under its ambit. That is a problem. Angel Tax finds its mention in Section 56(2)-(viib) of the Income Tax Act, 1961. It refers to the income tax payable on the capital raised by unlisted companies like startups *via* the issue of shares through off-market transactions.[15] Generally, it could be done by raising the prices of the shares. Angel Tax was levied on the capital raised *via* the issue of

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[13] Mayashree Acharya, Angel Tax: Exemption, Rate, Example, ClearTax, https://cleartax.in/s/angel-tax.

[14] Brian O'Connell, What Are Angel Investors? Forbes, https://www.forbes.com/advisor/in/investing/what-are-angel-investors/.

[15] CNBCTV18, https://www.cnbctv18.com/startup/cbdt-proposes-changes-to-tax-regulations-for-angel-investors 16714851.htm.

shares by an unlisted company from a resident investor.[16] Now, of course, from foreign investors as well. If the share price of the issued share is seen as more than the "fair market value" ("FMV") of the company (the fair market value of any share is the actual price you pay for purchasing that share) then the excess realization is viewed as "income from other sources"[17] and therefore taxed accordingly. If, for instance, a share costs 10 Rupees a piece but the company issues these shares at 20 rupees, the difference of 10 Rupees will be taxable as income from other sources according to the new Act. It's very important to mention that angel tax, despite its nomenclature, is applied to the company, not the investor.

VII

Origin

Generally, what used to happen earlier, was, that many resident investors used startups or unlisted companies to receive Angel investments as black money and convert them into white money. Investors used to dump large corpus of funds in low-valued companies for round-tripping (funds exiting the country through diverse channels and subsequently re-entering as foreign investments), and money laundering.[18] This caused a problem because that money was not taxed and the government was losing its revenue. So, in 2012's budget, the imposition of an Angel Tax was introduced.[19]

If we talk about the legal origin of the Angel tax, Section 56(2)-(viib), Income Tax Act, 1961 is colloquially known as Angel Tax. The Finance Act of 2012 incorporated this provision into the IT Act, which imposes taxes on any investment received by an unlisted Indian company, exceeding its FMV. This excess investment amount is treated as income from alternative sources. The tax is imposed as Angel Tax since it primarily affects Angel Investors investing in startups. The government's argument for introducing this tax was that, any affluent

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16 Rajesh Gandhi, Decoding the angel tax muddle, The Hindu Business Line, https://www.thehindubusinessline.com/blexplainer/bl-explainer-decoding-the-angel-tax-muddle/article66614411.ece.

17 Income Tax Act, 1961, S. 56.

18 Anand Jaiswal, India's Angel Tax, 30 INT'l TAX REV. 64 (2019).

19 Finance Act, 2012, S. 21(B).

person who has garnered a lot of black money but wants to show it as white money could become an Angel Investor. He could achieve two things from this; *first*, of course, the prominence of being an angel investor, and *second* turning the black money into white money. Other than that, on that black money, the investor could also earn profit.

Angel Tax is applicable when any unlisted company issues shares to resident investors at a price higher than its FMV. FMV is to be determined only through Book Value (Book Value is the value of any company's assets minus the liabilities) or Discounted Cash Flow Method (discounted cash flow method means calculating the value of any company concerning the future cash flows), failing which an Assessing Officer will intervene for assessment.[20]

VIII

Effects of the Amendment

The tax on startups intended to discourage money laundering via artificially inflated valuations has been controversial and frequently amended. Initially, it affected businesses receiving investments from resident Indians. However, in 2023-24 the Finance Act, 2023 amended the provision and extended the tax net to startups funded by non-resident Indians and overseas investors. This has been done by omitting the words 'being a resident' from clause (vii-b) of sub-section (2) of Section 56 of the IT Act, 1961.

This is worrisome because the funding for Indian startups has already dropped before the introduction of this amendment. Funding for India's startups dropped by 33% to 24 billion dollars in 2022.[21] The intense impact of the amendment on startups can only be comprehended by a layman when he sees that the Angel Tax is levied at 30.9% on net investments over the FMV.[22] Non-resident investors are

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[20] S Vasudevan, Prachi Bhardwaj, Angel tax in India: a retrograde step for foreign investment, International Tax Review, https://www.internationaltaxreview.com/article/2bjuhxdf1g65fgk7c10cg/sponsored/angel-tax-in-india-a-retrograde-step-for-foreign-investment.

[21] Economic Times, https://economictimes.indiatimes.com/tech/funding/startup-funding-in-india-drops-33-to-24-billion-in-2022-report/articleshow/96911190.cms?from=mdr.

[22] Mayashree Acharya, Angel Tax: Exemption, Rate, Example, ClearTax, https://cleartax.in/s/angel-tax.

a key source of funding for startups because resident investment is not flourishing for them, partly because of the imposition of the Angel Tax on them. Additionally, investments from non-residents are believed to constitute more than 90 percent of private capital invested in startups.[23] Furthermore, numerous non-resident investors, including Tiger Global, a highly active non-resident investor in the Indian startup market, have funded more than a third of the startups that have attained unicorn status, valued at a minimum of one billion dollars.[24] Also, because of the exclusion of non-resident investors from the tax net, the impact was restricted primarily to early-stage startups, as most of the capital in later stages comes from non-resident sources. Now, major emerging start-ups will be in a vulnerable position due to this amendment. The amendment will impact employment opportunities, skill upgradation, the interconnectedness of the market, and everything else.

This could compel more startups to flip overseas to more tax-friendly jurisdictions such as Singapore or UAE[25], and that will impact the employment opportunities in India. The reintroduction has come completely counterintuitive to the entire move of reverse-flipping. That is precisely what India doesn't want right now. India wants more employment opportunities and more flourishing ease of doing business opportunities for domestic start-ups. However, achieving these objectives necessitates adequate funding. In the absence of robust domestic funding sources, we become reliant on investment from non-resident entities. Yet, it's essential to address the critical concerns of black money and money laundering.

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[23] Binu Paul, Angel tax for non-resident investors: Here's why India's start-up ecosystem is worried, Business Today, https://www.businesstoday.in/magazine/the-buzz/story/angel-tax-for-non-resident-investors-heres-why-indias-start-up-ecosystem-is-worried-370610-2023-02-17.

[24] Manish Singh, India's startup funding slides 68% after Tiger and SoftBank make virtually no deals, Tech Crunch, https://techcrunch.com/2023/06/29/india-startup-funding-slides-after-tiger-and-softbank-make-virtually-no-deals/.

[25] Salman SH, More startups may opt for flip structure, Financial Express, https://www.financialexpress.com/business/sme-more-startups-may-opt-for-flip-structure-2973310/.

IX

Exemptions

Before the amendment, Angel Tax was subject to certain exemptions- whatever money companies raise is exempted till the total share capital plus the shared premium touches INR 25 crore.[26] This means that the total issued capital must remain significantly below INR 25 crore. Consequently, a startup that falls within this exemption threshold will not be subject to Angel Tax on the first INR 25 crore of the capital it raises. Moreover, this exemption can be applied across multiple funding rounds. For instance, a startup may raise INR 10 crore in one round, followed by 5 crores in another, and 6 crores in yet another, all of which would remain exempt from Angel Tax.

For the calculation of the above-mentioned INR 25 crore, funds received from Category 1 Alternate Investment Funds, Venture Funds, and Listed Companies with a net worth of INR 100 crore or a turnover of 250 crore in the previous year are exempt from the calculation.[27]
Furthermore, the Central Board of Direct Taxes ("CBDT") has also granted exemptions for startups registered under the Department of Promotion of Industry and Internal Trade ("DPIIT"). However, availing of these exemptions entails a thorough financial assessment and subsequent paperwork.[28]

Considering the uproar from industry players from all over the market, CBDT through a notification dated May 24th, 2023, has exempted 21 jurisdictions and Category 1 foreign portfolio investors that are SEBI-registered from the tax net.[29] These jurisdictions encompass Spain, Canada, Germany, Denmark, Austria, Japan, Australia, New Zealand, Russia, France, Belgium, United States, Italy, United Kingdom, Iceland, Norway, Korea, Israel, Sweden, and Finland. However, the inclusion of these developed economies is not as pleasing as it may appear. A

[26] Nishith Desai Associates, https://www.nishithdesai.com/NewsDetails/10618.
[27] Ministry of Commerce and Industry https://www.startupindia.gov.in/content/dam/invest-india/Templates/public/198117.pdf.
[28] https://www.startupindia.gov.in/content/sih/en/startup-scheme.html.
[29] https://incometaxindia.gov.in/communications/notification/notification-29-2023.pdf.

significant amount of non-resident investment in India flows from Singapore, Mauritius, Holland, Ireland, and the Cayman Islands.[30] To address the worries of businesses in India, the government needs to expand its list of 21 tax-exempt nations to include the aforementioned jurisdictions.

It is, nonetheless, important to note that the changes in angel tax shall be effective from assessment year 2024-25. Hence, non-resident investors have a window of opportunity to adjust their investment structures to avoid the implications of this amendment. To illustrate, when a venture capital undertaking issues shares to a domestic venture capital company, venture capital fund, or Alternate Investment Funds, any premium exceeding the established Fair Market Value (FMV) isn't subjected to taxation under the category of "Income from other sources." Consequently, such premiums continue to enjoy exemption from Angel Tax.

X

Conclusion

The elimination of residency requirements in the "Angel Tax" may affect shares issued and consideration received from April 1, 2023, onward. While the Indian government has granted exemptions to recognized startups and specified funds, the amendment could diminish the appeal for non-resident investors seeking to invest in India. It may also compel certain startups to contemplate structuring their holdings overseas as a way to reduce the consequences of this proposed amendment.

The initial implementation of the Angel Tax on resident investors had minimal impact on startups, largely due to the availability of ample non-resident funding. However, the recent extension of this tax to non-resident investors is expected to have adverse consequences on the economy. Nevertheless, the government's decision appears to prioritize countering black money over sustaining economic growth. The

[30] Live Mint, https://www.livemint.com/opinion/online-views/how-the-angel-tax-harms-indian-startups-11685431904734.html#:~:text=The%20so%2Dcalled%20'angel%20tax,a%20famously%20complex%20tax%20code.

intention seems well founded as though the inflow of black money provides capital to emerging start-ups, the concentration of wealth remains in the hands of few. Many of the exempted nations have efficient systems to identify money laundering, but even the investors from these nations, such as the US, Austria, etc choose to invest in India through Mauritius, Singapore, the Cayman Islands, and other nations not whitelisted. The Indian Government hasn't provided any explanation as to why hasn't it included three of the top seven sources of FDI in India. One can only speculate, that the reason is national security, as these 3 nations are also notorious as pooling destinations, with Singapore having a deep relationship with Chinese investors.[31]

Regardless, if the Government wants to realize its vision of Make in India, it'll have to find a middle path between the macroeconomic objective of countering black money and the microeconomic goals of finding opportunities for providing capital to start-ups.

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[31] Moneycontrol, https://www.moneycontrol.com/news/business/angel-tax-hit-on-mauritius-singapore-likely-to-exacerbate-startup-funding-winter-10664911.html.