livemint

Opinion | Burden of angel tax for start-up investors

Adequate controls need to be built in so that genuine investors are not scared away

Last Published: Mon, Jan 07 2019. 09 48 AM IST

Gautam Nayak

Enter email for newsletter Sign Up

Photo: iStock

How would you feel if you were to invest your tax paid funds into shares of a recently set-up company, and that company has to pay one-third of that money by way of income tax, though it is a loss-making company? Effectively, as an **investor**, you are losing one third of the value of your investment immediately. This is the story that has been playing out in

the last few months in the tax department, with the tax authorities levying income tax on various capital infusion by investors into companies.

There are two provisions under which such additions are being made. The first provision is in relation to unexplained cash credits, a provision which has been in the law for many years, but which has recently been amended to provide that besides having to prove the genuineness of the transaction and the identity and capacity of the investor, the recipient is also required to prove the source of the funds in the hands of the investor. Tax authorities are now insisting on not just the confirmation of the investor, but for a copy of the balance sheet and bank account of the investor to prove from where the investor got the funds.

Many are obviously reluctant to share their accounts with the investee company, and therefore additions are being made under this provision. Unfortunately, tax authorities are exceeding their brief, and insisting on proof of source of funds of the investor even in case of foreign investors, though the law is supposed to apply only to domestic investors. It is not only **start-ups** who face this problem, but even large companies which have received foreign funding by way of foreign direct investment.

Most foreign investors are obviously wary when a request is made by the investee company for such information, and obviously do not want to share it. Can we have such a law, which requires a company to prove something which is not within its control, or else penalizes the company? The law certainly needs drastic changes, or else adequate controls need to be built in so that genuine investors are not scared away.

The second provision (commonly referred to as "**angel tax**") under which additions are made is a provision under which a company is taxed if it charges a premium for its shares, where the amount received for allotment of the shares exceeds the fair market value of the shares. As is well known, many loss making companies, including e-commerce companies, tech start-ups, etc have high valuations, though they are currently incurring losses. These valuations are based on rosy future projections, assuming that the idea underlying the business will succeed. By the time the tax assessment comes up, in 9 out of 10 cases, the projections are not met. The tax officer, on the basis of hindsight, then refuses to accept the valuation, and values the company based on figures actually achieved. This results in large amounts of share premium being treated as income of the investee company.

There is a provision for registration of start-ups with the Inter-Ministerial Board of Certification of the government. Registered start-ups are exempt from the provision taxing excessive share issue price. However, such registration is restricted only to small companies with investments up to ₹10 crore, and for investors meeting certain criteria.

Investors would need to share their income and net worth with the investee companies for this purpose. Further, this exemption is available only from the current year, and does not apply to the past 3 years, for which this provision is currently being invoked. Therefore, a large number of companies, which are generally loss-making, are facing litigation on this account, effectively destroying what is left of such businesses.

In the meanwhile, the Central Board of Direct Taxes has clarified that no coercive action will be taken to recover tax demanded on account of rejection of valuation. But, this is not sufficient, as the tax demands have to be challenged in appeal. Further, the central government has promised to do something to address the situation.

But this leaves one with various questions. Should a receipt which is a capital receipt be taxed as income (which is a revenue receipt) at all? Given the fact that these provisions were introduced because of misuse by certain politicians and others to launder money, was it not appropriate to take action in those cases under other applicable Acts, rather than burden everybody with amendments to the income tax law which creates such chaos? Does the government want to encourage businesses, particularly start-ups, or restrict their ability to raise **funds** and carry on business?

Historically, the income tax law has been used to serve purposes other than collection of tax. This has made the law unmanageable and unwieldy. Perhaps the time has come to strengthen the mechanism under various other laws and use those appropriate laws to check offences under those laws, rather than try and use income tax laws to curb offences under other laws.

Gautam Nayak is a chartered accountant

First Published: Mon, Jan 07 2019. 07 46 AM IST

TOPICS: ANGEL TAX START-UPS INVESTORS TAXATION FINANCIAL PLANNING

EDITOR'S PICKS »