Timely Review: On Start-up Tax

(This editorial is based on the article "Timely Review: On Start-up Tax" which appeared in The Hindu for 6th February 2019. In this editorial, we'll discuss the concerns related to Angel Tax.)

As per findings of a survey conducted by Local Circles and the Indian Private Equity & Venture Capital Association (IVCA), **over 73% of startups that raised capital between Rs 50 lakh to Rs 2 crore in India have received angel tax notice(s) from the Income Tax Department** which created tensions in group of startups.

Start-ups troubled by the so-called angel tax may soon receive some concession from the government. **Recently, the Centre set up a five-member working committee to look into revising the norms of the angel tax imposed on start-ups.**

Background

The ‘angel tax’, as it is commonly called, is a tax on the excess capital raised by an unlisted company through the issue of shares over and above the fair market value of those shares. This excess capital is treated as income and taxed accordingly. This tax most commonly affects start-ups and the angel investors who back them. Angel tax was introduced in 2012, with the purpose of keeping money laundering in check.
Start-up owners have complained that income tax officials have asked many startups to cough up money when they try to attract capital into their entities by issuing new shares.

For its part, the IT department fears that start-ups may be used as convenient tools to launder illegally acquired money, so a tax on investments beyond a certain threshold is necessary to deter such shady operations.

Who is Angel Investor?

- **An angel investor is a wealthy individual that agrees to invest in a small startup** company that has little access to capital.
- Typically, angel investors are entrepreneurs who may also be friends or relatives of the person starting the company.
- **They believe in the company’s founders, as well as their business concept**, and they loan the capital needed for the fledgling company to get off the ground, generally at more favorable loan terms than other lenders.
- **Often, angel investors want their investment to remain private.** In return for their support, angel investors usually receive ownership in the new company, often in the form of preferred stock.

Concerns

- **In trying to curb money-laundering, Section 56(2)(vii)(b) of the Indian Income Tax Act, 1961 gives income tax officials discretionary powers to inspect startups looking to raise investments for their growth which result into harassment of genuine startups.**
- Under the Act, the IT department is free to arbitrarily decide the fair value of a company’s share and tax start-ups if the price at which their new shares are sold to investors is higher than the fair value of these shares.

- Angel Tax was, therefore, can be considered as problematic for a few reasons. For one, **valuing startups based on their assets alone, given intangibles such as goodwill is not easy.** Nor is it easy to arrive at ‘fair value’ for them, based on discounted cash flows. So, startups are often valued subjectively and the valuation which seems sky-high to some may be fair to others.
- Two, **higher valuations when raising funds, are beneficial to founders as it means giving up less equity.** But given the closed nature of these deals, there were concerns on whether there was creative financial planning happening.
- While the intent of such an angel tax may be justifiable, **the arbitrary nature of it means the cost of unintended consequences could be larger than the supposed benefits.**

Way Forward

- The broad-brush tax on all investments means an unnecessary cost is imposed on the wider start-up community simply because of the lack of better means at the government’s disposal to tackle black money.
- **The committee set up by the government should consider raising the threshold beyond which new investments into startups will be taxed.**
- It is expected that start-ups with aggregate paid-up share capital and share premium of less than ₹25 crore, against the previous threshold of only ₹10 crore, will not be taxed while attracting new investment.
- This would definitely make life easier to a certain extent for angel investors and startups. But it will not address the real problem with the angel tax, which has to do with the unbridled power that it vests in the hands of the income tax authorities.
- Investors, foreign or domestic, may become wary of investing in new ideas when they are taxed while risking money on untested ventures. So the **government should look to rationalize the angel tax** and focus instead on building the capability to better identify and rein in illegal wealth. **Otherwise, it risks killing the nascent startup ecosystem in the country.**