

# ET IN THE CLASSROOM: WHAT IS ANGEL TAX?

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Taxation & Black Money

## ANGEL TAX

In what has again triggered tax issues, several startups are receiving income tax notices on angel funding they received few years ago. The government has said no coercive action will be taken to recover the demand and has set up a committee to review the entire issue.

## WHAT IS ANGEL TAX?

[Angel tax](#) is a term used to refer to the income tax payable on capital raised by unlisted companies via issue of shares where the share price is seen in excess of the fair market value of the shares sold. The excess realisation is treated as income and taxed accordingly. The tax was introduced in the 2012 Union Budget by then finance minister [Pranab Mukherjee](#) to arrest laundering of funds. It has come to be called angel tax since it largely impacts angel investments in startups.

## IS AN EXEMPTION AVAILABLE FROM THIS TAX?

The government issued a notification in April this year to give exemption to startups under Section 56 of the Income Tax Act in cases where the total investment including funding from angel investors did not exceed Rs 10 crore. For the exemption, startups were also required to get approval from an inter-ministerial board and a certificate of valuation by a merchant banker. According to the notification, the exemption would apply only when the [angel investor](#) had a minimum net worth of Rs 2 crore or an average returned income of over ₹25 lakh in the preceding three financial years.

## WHY HAS THE INDUSTRY RAISED THE ISSUE OF VALUATION OF STARTUPS?

The share issued to an investor has to be valued to decide whether the price is in excess of fair value. The industry has demanded that the discounted cash flow (DCF) method of valuation be used to calculate angel tax instead of the net asset value (NAV) method, though even that may not capture the true value of a startup. The valuation of a startup is usually based on a commercial negotiation between the company and the investor, and is a function of the company's projected earnings at that point in time. However, since startups operate in a highly uncertain environment, many companies are not always able to perform as per their financial projection. Equally, some companies exceed the projection by a long mile if they are doing well.

## WHAT IS THE LATEST ISSUE? WHAT HAS THE GOVERNMENT DONE?

At least 80 startups have received notices to pay angel tax since last year. Many founders have said they have been asked to pay up as much as 30% of their funding as tax. Angels have also received multiple notices asking them to furnish details on their source of income, their bank account statements and other financial data. Procuring valuations from merchant bankers is also a more expensive proposition for startups than going through chartered accountants. For those who have been issued notices, charges are piling up for chartered accountant fees for filing an appeal. The government has said no coercive action will be taken to recover the demand and has set up a committee to review the entire issue.

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