



**Newsflash**  
**CBDT proposes amendments to Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax**

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### CBDT proposes amendments to Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax

*For Circulation*  
*9 June 2023*

#### 1. Background

- 1.1 The Finance Act 2012 introduced Section 56(2)(viib) under the Income-tax Act (“Act”), as an anti-abuse provision to deter generation and use of unaccounted money through share premium received from resident investors in a closely held company in excess of its fair market value (‘FMV’).
- 1.2 Section 56(2)(viib) provides that where a closely held company issues shares to a resident investor at a value higher than the face value of such shares, then the excess of the issue price over the FMV will be taxed as income under the head “Income from other Sources” in the hands of the company issuing the shares. Such excess consideration is commonly referred to as “**Angel Tax**”. However, the said provision would not be applicable in certain cases where the issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund or a specified fund. Further, CBDT vide **Notification No 13/ 2019 and Circular 16/ 2019**, clarified that the said provision will not apply to start-ups recognized by Department for Promotion of Industry and Internal Trade (‘DPIIT’), subject to fulfillment of certain conditions.
- 1.3 Prior to Finance Act 2023, the above proviso was not applicable in the case of consideration received from non-resident investors. With an intent to widen the tax base and eliminate the possibility of tax avoidance, the Finance Act 2023, w.e.f. 01.04.2023, extended the applicability of the extant provisions to any person irrespective of the residential status, thereby, extending the scope of ‘Angel Tax’ to non-residents as well.

Post such amendment, there has been a lot of hue and cry amongst various stakeholders who expressed their concerns regarding the potential repercussion of implementing the above-mentioned provisions to non-residents.

- 1.4 Valuation of shares has consistently been a contentious matter leading to numerous legal disputes. In addition, fundraising from non-resident investors is also subject to regulations under the Foreign Exchange Management Act (‘FEMA’).
- 1.5 Under the Act, FMV of the unquoted equity shares is determined in accordance with the method prescribed under Rule 11UA of the Rules i.e. either through the book value method (‘NAV’) or the discounted cash flow (‘DCF’) method, at the option of the company. In case where shares are issued at a price higher than the FMV, then in such a scenario, the excess share premium is taxable in hands of issuer company. However, as per FEMA regulations,

shares are to be valued as per any of the internationally accepted valuation methodologies and the price at which shares are to be issued shall be equal to or higher than the FMV.

- 1.6 Due to the conundrum brought in by the amendment and the non-alignment of the valuation methodologies under various regulations, non-resident investors have been facing additional challenges to satisfy the requirements under the Act and FEMA. This inconsistency could open a Pandora's box of litigation in the near future.
- 1.7 In this regard it is notable that CBDT has issued a **Press release on May 19, 2023**, which has been tabled for public comments, before being notified proposing certain amendments in Rule 11UA of the Rules for valuation of shares.

A brief summary of the Press Release dated May 19, 2023, is as under:

## **2. Amendments proposed in Rule 11UA under the Press Release:**

- 2.1 Currently, Rule 11UA outlines two valuation methods, namely DCF and NAV, for valuing shares issued to resident investors. **The proposal is to expand the options by including 5 additional valuation methods specifically for non-resident investors, in addition to the existing DCF and NAV methods.**
- 2.2 If a company receives consideration for the issuance of shares from a non-resident entity notified by the Central Government, the price of the equity shares related to that consideration can be considered as the FMV of the equity shares for both resident and non-resident investors. However, this is subject to the following conditions:
  - i. To the extent the consideration from such FMV does not exceed the aggregate consideration that is received from the notified entity and
  - ii. The consideration has been received by the company from the notified entity within a period of 90 days of the date of issue of shares which are the subject matter of valuation.

It has been clarified that on similar lines, price matching for resident and non-resident investors would be available with reference to investment by Venture Capital Funds or Specified Funds in venture capital undertakings.

- 2.3 It is proposed that the valuation report by the Merchant Banker for the purposes of this rule would be acceptable, if it is of a date not more than 90 days prior to the date of issue of shares which are subject matter of valuation.
- 2.4 In order to accommodate foreign exchange fluctuations, bidding processes, and changes in other economic indicators that could impact the valuation of unquoted equity shares during multiple rounds of investment, a safe harbour provision is proposed. This provision would allow for a variation of up to 10% in the value of the shares.

## 2.5 Non-resident investors to whom clause (viib) of sub-section (2) of section 56 of the Act is proposed to be not applicable are as under:

- (i) Government and Government related investors such as Central banks, Sovereign Wealth Funds, International or Multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75% or more.
- (ii) Banks or Entities involved in Insurance Business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident.
- (iii) Any of the following entities, which is a resident of a certain countries or specified territories having robust regulatory framework: -
  - Entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors.
  - Endowment Funds associated with a university, hospitals or charities,
  - Pension Funds created or established under the law of the foreign country or specified territory,
  - Broad Based Pooled Investment Vehicle or Fund where the number of investors in such vehicle or fund is more than 50 and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies.

## 2.6 For Investment in Start-ups

It is also proposed to modify **Notification No. S.O 1131(E) dated 5th March, 2019** so as to provide that the provisions of section 56(2)(viib) of the Act shall not apply to consideration received from any person by start-ups covered in para 4 & 5 of Notification dated 19.2.2019 issued by the Ministry of Commerce and Industry in the DPIIT.

## 3. Notifications brought in by the CBDT

3.1 The CBDT vide **Notification no 29 / 2023 dated May 24<sup>th</sup>, 2023<sup>1</sup>** has notified the class or classes of persons to whom the provisions of 'Angel Tax' shall not be applicable. The excluded list includes the following -

- Government and Government related investors such as central banks, sovereign wealth funds, international or multilateral organizations or agencies including entities controlled by the Government or where direct or indirect ownership of the Government is 75 percent or more;

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<sup>1</sup> <https://incometaxindia.gov.in/communications/notification/notification-29-2023.pdf>

- Banks or Entities involved in Insurance Business where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident;
- Entities which are resident of the 21 listed countries / territories, and where such entity is subject to applicable regulations in the country where it is established or incorporated or is a resident :—
  - (a) entities registered with Securities and Exchange Board of India as Category-I Foreign Portfolio Investors
  - (b) endowment funds associated with a university, hospitals or charities
  - (c) pension funds created or established under the law of the foreign country or specified territory
  - (d) Broad Based Pooled Investment Vehicle or fund where the number of investors in such vehicle or fund is more than fifty and such fund is not a hedge fund or a fund which employs diverse or complex trading strategies

The list of the 21 countries / territories are as under:

- |                   |             |                    |
|-------------------|-------------|--------------------|
| 1) Australia      | 8) France   | 15) New Zealand    |
| 2) Austria        | 9) Germany  | 16) Norway         |
| 3) Belgium        | 10) Iceland | 17) Russia         |
| 4) Canada         | 11) Israel  | 18) Spain          |
| 5) Czech Republic | 12) Italy   | 19) Sweden         |
| 6) Denmark        | 13) Japan   | 20) United Kingdom |
| 7) Finland        | 14) Korea   | 21) United States  |

From the above, it is pertinent to note that while funds / entities resident of jurisdictions such as – US, UK, Australia, etc. are excluded from ‘Angel Tax’, **however, few jurisdictions such as - Singapore, Mauritius, Cayman, Cyprus, Netherlands, UAE, which are usually the major FDI related countries, have not been considered and hence, investment raised from funds registered in these countries will not be exempt.**

- 3.2 In addition to the above, the CBDT vide ***Draft Notification dated May 26<sup>th</sup>, 2023<sup>2</sup>***, has issued proposed amendments to Rule 11UA w.r.t the valuation methodologies. The Draft Rules are up for public consultation and open for suggestions / comments from public till June 5<sup>th</sup>, 2023.

The highlights of the abovementioned notification with proposed amendments in Rule 11UA are as under-

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<sup>2</sup> <https://incometaxindia.gov.in/news/11ua-public-comments.pdf>

- (i) **Introduction of 5 new valuation methods for non - resident Investors** – Five additional methods have been introduced for computing the FMV of unquoted shares issued to non-resident investors. These methods are as under-
  - Comparable Company Multiple Method
  - Probability Weighted Expected Return Method
  - Option Pricing Method
  - Milestone Analysis Method and
  - Replacement Cost Method
  
- (ii) **FMV Benchmarking for other Investors-** In a scenario where a company receives consideration for share issuance from a notified entity, the price of the equity shares corresponding to that consideration can be considered as the FMV for other investors. Such benchmarking is applicable only to the aggregate consideration received from the notified entity, subject to the company receiving the consideration within 90 days of the share issuance. Similar price matching facility would also be applicable in case of for resident and non-resident investors with reference to investment by Venture Capital Funds or Specified Funds in venture capital undertakings.
  
- (iii) **Upper limit of 90 days on the validity of the valuation report of the Merchant Banker -** The valuation report provided by the Merchant Banker will be acceptable only if it is not more than 90 days old from the date of share issuance.
  
- (iv) **Introduction of 10% safe harbour limit** - A 10% safe harbour limit has been introduced by the Government as per which if the issue price of the shares exceeds the value determined per Rule 11UA by no more than 10%, then, the issue price will be considered as the FMV.

#### 4. Our comments and key takeaways

- 4.1 The aim of the Press Release and Draft Notification is to resolve the dilemma and various issues being faced by stakeholders at large. As more valuation methods in addition to DCF and NAV are proposed, the additional valuation methods will provide more options to arrive at a robust valuation mechanism.
  
- 4.2 Adequate relief has been provided with respect to investments received from certain Foreign Portfolio Investors and Pooled Investment Vehicles by covering them under the ambit of excluded entities.
  
- 4.3 The worries of the Start-up community has been reduced by specifically excluding the Start-ups which meet the DPIIT recognition criteria from the applicability of tax, thereby, strengthening India's Start-up eco system by giving a boost to their growth.
  
- 4.4 Introduction of safe harbour of 10% variation in value is a considerate move in the current dynamic market conditions and will create a conducive environment for investments.



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This Newsflash summarizes on the amendments proposed to Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax. It may be noted that nothing contained in this newsflash should be regarded as our opinion and facts of each case will need to be analyzed to ascertain applicability or otherwise of the said judgement and appropriate professional advice should be sought for applicability of legal provisions based on specific facts. We are not responsible for any liability arising from any statements or errors contained in this newsflash.

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9 June 2023

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