Newsflash:
CBDT amends Rule 11UA of Income Tax Rules, 1962 in respect of Angel Tax

THE POWER OF BEING UNDERSTOOD

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1. Background

1.1 Section 56(2)(viib) provides that where a closely held company issues shares (including preference shares) to a resident as well as non-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".**

1.2 The CBDT vide ***Notification No. 29/ 2023 dated May 24, 2023*** enlisted the categories of persons with respect to whom the provisions of Section 56(2)(viib) shall not be applicable. The details of such exempted persons have been discussed in detail in our Newsflash dated 9th June 2023[1].

1.3 In addition to the above, the CBDT vide ***Draft Notification dated May 26th, 2023***, has issued proposed amendments to Rule 11UA w.r.t the valuation methodologies which were up for public consultation and open for suggestions / comments. Such proposed amendments have also been discussed in the aforesaid Newsflash.

1.4 Post public consultation, the CBDT vide ***Notification No - 81/ 2023 dated September 25, 2023***[2]***,*** has now notified the final amended Rule 11UA for valuation of shares, including Compulsorily Convertible Preference Shares (CCPS).

1.5 The said notification is in line with the Draft Rule 11UA issued via Notification dated May 26, 2023, except with respect to CCPS for which separate valuation mechanism has been provided in the final amended Rule 11UA.

A brief summary of the ***Notification No. 81/ 2023 dated September 25, 2023*** is as under:

2. Amendments made in Rule 11UA under the Notification:

2.1 **<u>Introduction of 5 new valuation methods for Non - resident Investors</u>**

Erstwhile, Rule 11UA outlined two valuation methods, namely DCF and NAV, for valuing equity shares issued to resident investors. The amended Rule 11UA now has introduced 5

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[1] https://www.rsm.global/india/insights/newsflash-cbdt-proposes-amendments-rule-11ua-income-tax-rules-1962-respect-angel-tax
[2] https://incometaxindia.gov.in/communications/notification/notification-81-2023.pdf

additional valuation methods only for non-resident investors, in addition to the existing DCF and NAV methods which are as under-

(i) Comparable Company Multiple Method;
(ii) Probability Weighted Expected Return Method;
(iii) Option Pricing Method;
(iv) Milestone Analysis Method; and
(v) Replacement Cost Method

2.2 **Separate Valuation Mechanism for Compulsory Convertible Preference Shares (CCPS)**

The amended Rule 11UA, in addition to the separate mechanism for arriving at the FMV of CCPS (i.e., in accordance with DCF and the five new additional valuation methods, as specified above) also provides that the valuation of CCPS be based on the FMV of unquoted equity shares determined using any of the methods prescribed under the said Rule.

However, preference shares other than CCPS shall continue to be valued as per Open Market Value (OMV) based on the valuation report obtained from the merchant banker on the valuation date.

2.3 **Introduction of Price Matching Facility**

If a closely held company receives consideration for the issuance of equity shares or CCPS from any entity (i.e. resident or non-resident) notified by the Central Government, the price of the equity shares or CCPS related to that consideration can be considered as the FMV of such shares for both resident and non-resident investors subject to the following:

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 closely held company from the notified entity within a period of 90 days before or after the date of issue of shares which are the subject matter of valuation.

Similar price matching facility for resident and non-resident investors has been made available with reference to investment by Venture Capital Fund or Venture Capital Company or Specified Funds in a Venture Capital undertaking.

2.4 **Deemed Valuation Date for Merchant Banker Valuation**

Initially under Rule 11UA, merchant banker valuation report was required as on date of issue of shares. With the amended Rule 11UA brought by this notification, it has been provided 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 such shares which are the subject matter of valuation.

Further, the amended Rule 11UA contains a proviso as per which if such option is exercised, the provisions of Rule 11U(j) of the Rules shall not apply which defines 'valuation date' as the date on which the property or consideration is received by the Assessee.

2.5 **Safe Harbor - Applicable to Unquoted Equity shares and CCPS**

Erstwhile Rule 11UA did not provide for any safe harbor valuation tolerance limit. However, to accommodate foreign exchange fluctuations, bidding processes, and changes in other economic indicators that could impact the valuation of unquoted equity shares or CCPS during multiple rounds of investment, a safe harbor provision has now been provided. However, the said safe harbor limit would not be applicable in case where the FMV is determined using the price matching facility as aforementioned.

This provision would allow for a variation of up to 10% in the value of such shares determined using NAV method, DCF method or any of the above specified additional 5 methods, with respect to residents or non-residents, as the case may be.

Further, the amended Rule 11UA also explains that the 'issue price' for the said purposes shall mean the consideration received by the closely held company for one share.

3. Our comments and key takeaways

3.1 Introduction of safe harbor of 10% variation in value is a considerate move in the current dynamic market conditions and will create a conducive environment for investments.

3.2 The aim of the Notification / amended Rule 11UA is to resolve the dilemma and various issues being faced by stakeholders at large. The amendments seem to solve the anomaly between the valuation methodologies under the Act and FEMA by introducing five more valuation methods in addition to DCF and NAV. The additional valuation methods will assist in having a more accurate and robust valuation mechanism.

3.3 The notified entities such as registered start-ups etc. and also venture capital undertaking may not be required to undergo valuation exercise in case where it is receiving investment within a time span of 90 days from the last date of issue of shares.

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