

Angel Taxation and Issues under section 56(2)(x)

CA Anil Sathe 14th April 2019

Angel Taxation under section 56(2)(viib)

What is Angel Investing

- A person who makes initial investment in a start up / entrepreneurial company is commonly known as an 'Angel Investor'
- Typically, Angel Investors are high net worth individuals (HNIs) who invest their own funds, as against venture capitalists
- Angel Investors typically make investment in a novel concept having regard to the future earning potential of the same

Section 56(2)(viib)

“(viib) where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:

Provided that this clause shall not apply where the consideration for issue of shares is received—

- (i) by a venture capital undertaking from a venture capital company or a venture capital fund; or*
- (ii) by a company from a class or classes of persons as may be notified by the Central Government in this behalf.*

Explanation.—For the purposes of this clause,—

(a) the fair market value of the shares shall be the value—

- (i) as may be determined in accordance with such method as may be prescribed; or*
- (ii) as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature,*

whichever is higher;

(b)...”

Conditions for attracting section 56(2)(viib)

- ❖ Shares are issued by a Closely Held Company (CHC) at premium
- ❖ Consideration is received from a resident
- ❖ Such consideration is in excess of Fair Market Value of shares

Object behind insertion of section 56(2)(viib)

- While explaining the object of insertion of section 56(2)(viib), Hon'ble Finance Minister in his budget speech 2012 had stated as under:

“... to deter the generation and use of black money, I propose to.... Increase the onus of proof on closely held companies for funds received from shareholders as well as taxing share premium in excess of fair market value”

- Thus it appears that section 56(2)(viib) is an anti-abuse provision meant to curb circulation of unaccounted money

Section 68

“68. Where any sum is found credited in the books of an assessee maintained for any previous year, and the assessee offers no explanation about the nature and source thereof or the explanation offered by him is not, in the opinion of the Assessing Officer, satisfactory, the sum so credited may be charged to income-tax as the income of the assessee of that previous year :

Provided that where the assessee is a company (not being a company in which the public are substantially interested), and the sum so credited consists of share application money, share capital, share premium or any such amount by whatever name called, any explanation offered by such assessee-company shall be deemed to be not satisfactory, unless—

(a) the person, being a resident in whose name such credit is recorded in the books of such company also offers an explanation about the nature and source of such sum so credited; and

(b) such explanation in the opinion of the Assessing Officer aforesaid has been found to be satisfactory:

Provided further that nothing contained in the first proviso shall apply if the person, in whose name the sum referred to therein is recorded, is a venture capital fund or a venture capital company as referred to in clause (23FB) of section 10”

Angel Tax controversy – A Background

- **Section 56(2)(viib) of the Income Tax Act provides that if a Closely Held Company (CHC) issues shares at premium and the issue price exceeds the Fair Market Value (FMV) of shares, then the share premium shall be chargeable to tax in the hands of the company**
- **For the purpose of section 56(2)(viib) valuation of unquoted equity shares is to be determined in accordance with Rule 11UA(2), wherein an option has been granted to assessee to adopt either DCF method of valuation or the Net Asset Value method**
- **Proviso to Section 68 of the Income Tax provides that in case of a CHC, where any sum credited in its books of accounts consists of share premium etc., unless the person in whose name such credits stands also gives a satisfactory explanation as to its nature & source, such sum credited shall be deemed to be unexplained cash credit in hands of the CHC**

Angel Tax controversy

- Recently, there have been a large number of instances where the Income Tax Department has sought to invoke the provisions of section 56(2)(viib) by challenging the valuation of shares, and/or provisions of section 68 in hands of start-up companies
- Typically, investment in start-ups is made not on the basis of its current earning or value of asset base, but considering the future earning capacity and therefore, the valuation of shares is done on the basis of Discounted Cash Flow (DCF) method of valuation, by estimating the future cash flows.
- The problem arises when the actual cash flows post share issue do not match the estimates considered for determining valuation

Angel Tax controversy

- The Income Tax Department in number of such cases has rejected the valuation on the ground that initial projected cash flows are less than actual cash flows post share issue till the date of assessment and has proceeded to make an addition in hands of the company by adopting much lower valuation on the basis of actual cash flows
- The arbitrary additions made by the Tax Officers u/s 56(2)(viib) in case of start-ups by rejecting the valuation adopted by these companies and adopting a far lesser valuation (which is arrive at either without any reasonable basis or on the basis of actual cash flows) has caused great hardship to the start-ups

Angel Tax controversy

- Similarly, provisions of the first proviso to section 68 are also being invoked by the Income Tax Department in hands of the start-ups by treating the explanations offered by the Angel Investors as not satisfactory
- First proviso to section 68 was inserted w.e.f. 1-4-2013 with the intention to place higher onus of establishing the source of investment on companies, considering that generally investment in CHCs is made by known persons
- However, in peculiar case of start-ups, where an idea is floated by one person and investment is made by another person (angel investor), invocation of section 68 is causing hardship even though the investment is genuine
- In addition to invoking provisions of section 56(2)(viib) and section 68 in many cases penalty u/s 271(1)(c) is also being levied by the Tax Officers

Measures already in place to grant relief to start-ups

- In exercise of the powers conferred by the clause (ii) of the proviso to clause (viib) of sub-section (2) of section 56 of the Income-tax Act, 1961 (43 of 1961), a notification No. 45/2016 dated 14 June 2016 has been issued by the Central Government to exempt applicability of the said section in case where investment is made by a resident in shares of a 'startup' company.
- For the purposes of this notification, "startup" means a company which fulfills the conditions specified in the notification of the DIPP bearing number G.S.R.I 80(H), dated the 17th February, 2016 (superseded by G.S.R. No.365(E) dated 11 April 2018)
- CBDT has issued an instruction dated 6 February 2018 to the effect that in case of start up companies which fall within the definition given in Notification of the Department of Industrial Policy and Promotion (DIPP) in G.S.R. 501(E) dated 23-5-2017 (superseded by Notification no. G.S.R. 364(E) dated 11 April 2018), if additions have been made by the Assessing Officer under section 56(2)(viib) of the Act after modifying/rejecting the valuation so furnished under rule 11UA(2), no coercive measure to recover the outstanding demand would be taken

- Definition of a startup as per Notification No. G.S.R. 364(E) dated 11 April 2018 as modified vide Gazette Notification No. G.S.R. 34 (E) dated 16th January 16, 2019 and superceded by notification dated 19th February 2019 reads as under:

“1. ..(a) An entity shall be considered as a Startup:

- i. Upto a period of **ten years** from the date of incorporation/registration, if it is incorporated as a private limited company (as defined in the Companies Act, 2013) or registered as a partnership firm (registered under section 59 of the Partnership Act, 1932) or a limited liability partnership (under the Limited Liability Partnership Act, 2008) in India.*
- ii. Turnover of the entity for any of the financial years since incorporation/ registration has not exceeded **Rs. 100 crore***
- iii. **Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.***

Provided that an entity formed by splitting up or reconstruction of an existing business shall not be considered a Startup.”

Issues being faced by startups

- Due to restrictive definition of 'startup' as per the DIPP notification, many genuine startup companies are not entitled for the benefit of Notification No. 45/2016 dated 14 June 2016 for exemption from applicability of section 56(2)(viib)
- Similarly, such startup companies are also not able to take benefit of CBDT Instruction dated 6 February 2018 against coercive measures of recovery where addition has been made u/s 56(2)(viib)
- So far as applicability of section 68 is concerned, in absence of any specific provision to exempt genuine cases, startups are facing great hardship

Other Issues pertaining to section 56(2)(viib)

- Interplay between section 56(2)(viib) and section 68
 - Sunrise Academy of Medical Specialities (India) (P.) Ltd. v. ITO (257 taxman 373) (Ker HC)
 - Royal Rich Developers v. DCIT (ITA NO. 1835/Mum/2014) (Mum ITAT)

Other Issues pertaining to section 56(2)(viib)

- Whether purposive interpretation can be adopted while determining applicability of section 56(2)(viib)
 - Vaani Estates Pvt. Ltd. (172 ITD 629) (Chennai ITAT)

Other Issues pertaining to section 56(2)(viib)

- Whether AO can substitute the method of valuation adopted by the assessee as per rule 11UA(2)
 - Ozoneland Agro Pvt. Ltd (ITA 4854/Mum/2016)
 - Rameshwaram Strong Glass (P.) Ltd (172 ITD 571) (Jaipur ITAT)
- Whether actual financial results post share issue can be a basis to challenge valuation as on the date of issue of shares
 - Innoviti Payment Solutions (P.) Ltd. (102 taxmann.com 59) (Bang ITAT)

Other Issues pertaining to section 56(2)(viib)

- Interpretation of term 'receives' as appearing in section 56(2)(viib)
 - Whether transaction has to be bilateral
 - whether Part IX conversion will attract the provisions of section

Other Issues pertaining to section 56(2)(viib)

- Whether redeemable non-cumulative preference shares will get covered u/s 56(2)(viib)
 - Microfirm Capital (P.) Ltd. (168 ITD 301) (Kol ITAT)

Issues under section
56(2)(x)

Brief Introduction

A. Gift Tax Act 1958 :

In India, taxing the gifts is not new and uncommon. For the first time, the gifts in India were brought under tax on and from 01.04.1957 (AY 1958-1959 onwards) under the Gift Tax Act, 1958. The gift tax was payable by the person making the gift (donor) at the following rates:

- a) Ranging from 5% to 75% on the taxable gifts made during the period from 01.04.1957 to 31.03.1987
- b) 30% of the taxable gifts made during the period from 01.04.1987 to 30.09.1998.
- c) W.e.f. 01.10.1998 the Gift tax Act, 1958 was repealed.

B) Gift Tax Free Regime:

No tax was levied on gifts made from 01.10.1998 to 31.08.2004

Back Door Entry of Tax on Gifts

- On and from 01.09.2004 taxable gifts received by the Individual or HUF /Any person(w.e.f. 01-04-2017) were brought under Income Tax by taxing such gifts under the head “Income from other Sources” by introducing sec. 56(2)(v), sec. 56(2)(vi), sec. 56(2)(vii) and sec. 56(2)(x).

Underlying Object to bring Sec 56(2) on Statute

- **Fin Minister speech of 2004:** Hon'ble Members are aware that I abolished the gift tax in 1997. That decision remains, but a loophole requires to be plugged to prevent money laundering
- **FM's Speech while moving FB 2012:** *"I propose a series of measures to deter the generation and use of unaccounted money To this end, I propose:taxing share premium in excess of fair market value."*
- **Explanatory Note to Fin. Bill 2017 :** These anti-abuse provisions are currently applicable only in case of individual or HUF and firm or company in certain cases. Therefore, receipt of sum of money or property without consideration or for inadequate consideration does not attract these anti-abuse provisions in cases of other assessee

Underlying Object to bring Sec 56(2) on Statute (Contd.)

- The Supreme Court in Allied Motors Pvt. Ltd., vs. CIT reported in 224 ITR 677 observed that The finance ministers budget speech explaining the provisions are relevant in construing the provisions
- Section 56(1) provides that income of any kind which is includible in total income of the person and not covered by clause A to E of section 14 of the act will only be covered in the residual clause “F” of section 14 that is “income from other sources”

Section 56(2)(x)

- 56(2): In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head “Income from other sources”, namely:—

(x) where any person receives, in any previous year, from any person or persons on or after the 1st day of April, 2017,—

- a) any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees, the whole of the aggregate value of such sum*
- b) any immovable property,—*

(c) any property, other than immovable property,—

(A) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

(B) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration

Scope

- **Coverage:** This section has widened the scope of the sunset section 56(2)(vii) by covering any person as defined in section 2(31) who receives from any person certain properties subject to 11 exceptions given in the proviso said clause.
 - **Exemption Limit:**
 - a) **Sum of Money:** The some of money received upto Rs.50,000/- not taxable but if exceeds Rs.50,000/- entire sum of money is taxable.
 - b) **Immovable Property:**
 - Received without consideration if stamp duty value of such imm prop does not exceed Rs.50,000/- -- not taxable.
- However, if the SDV of such prop exceeds Rs.50,000/- , entire SDV is taxed.
- If SDV exceeds the consideration, the said excess is taxable if such excess, exceed/more than the higher of the following two:
 - (i) Rs.50000/- and
 - (ii) 5% of the consideration

Scope (Contd.)

(c) Property other than Immovable Property:

- **Without Consideration:** If the aggregate FMV of the specified properties is upto Rs.50,000/- -- No Tax

However, if the aggregate FMV exceeds Rs.50,000/- the entire aggregate FMV of specified Properties will be taxed.

- **Inadequate Consideration:** If the aggregate FMV of other properties exceed the aggregate consideration and in such excess is below Rs.50,000/- then No tax.

Whereas, such excess exceeds Rs.50,000/- entire excess of the specified properties shall be taxable.

Issues- Consideration

- Where the amount received on accident as compensation from insurance company?
- Alimony received in case of divorce by wife?
- Amount received from unregistered NGO from local social group for education?
- Long term interest free loan received by the individual for overseas education?
- Whether shares received by shareholder as bonus shares or right shares covered u/s 56(2)(x)?

Ref: Sudhir Menon HUF v ACIT (Mum)[(Trib)]; SubodhMenon (Mum) and also refer Circular CBDT 3/2019

Issues - Sum of Money/Property

- Mr. A, non resident has come to India and paid \$ 10,000 to his remote cousins. Whether covered by sec.56(2)(x)(a)?
- Sum of Money presented to the leader by her followers on her birthday or winning the elections are taxable in the hands of leader?

Ref: Mayawati (Del ITAT)

Issues - Immovable Property

➤ **Whether Immovable property includes;**

- a. Development rights
- b. TDR
- c. Tenancy rights
- d. Lease rights

Issues- Exception-Relatives

- Gift received by Minor exceeding Rs.50,000/- to be clubbed in the hands of one of the parent exception such as relative to be checked in relation to the donee or the parent
- Family Settlement: Any property received on account of family settlement from cousins (not relatives u/s 56(2)(x)) whether taxable?

Issues- Exception-Relatives (Contd.)

- **Gift from and to HUF:**

Gift received by HUF from its members are specifically exempt however gift received from members from its HUF are exempt in case

- i. All members are relatives as per definition of relative u/s 56(2)
- ii. Some of the members are cousins but not relative within the definition of relative u/s 56(2).

Ref: Vineetkumar R. Bhalodia (Raj)

Issues- Exception-On Occasion of Marriage of Individual

- **Whether gifts on occasion of the marriage cover the following:**
 - Gifts only on the “day” of marriage?
 - Gifts on subsequent marriages?
 - Gifts received on engagement?
 - Gifts on pre-wedding party?
 - Gift received in kind?

Issues- Exception-Gift received in Contemplation of Death

- **Whether the following gifts will be treated as gifts in Contemplation of Death and shall be covered by exception;**
 - Gifts made by a soldier just before going on war front
 - Gift by a person suffering from incurable disease but not lying on death bed
 - A patient giving gifts before undergoing critical operation

- **As per section 191 of Indian Succession Act, 1925, immovable property cannot be gifted in contemplation of death.**
 - Will immovable property being transferred in contemplation of death be covered by exception to sec. 56(2)(x)?

Issues- Exception-Gift received in Contemplation of Death (Contd.)

- If the donor survives, the gift made in contemplation of death returns back to donor.
 - Under sec. 56(2)(x) whether such condition of returning the gift to donor is contemplated?
- Gift made in contemplation of death must be delivered by the donor in his lifetime to Donee.
 - Whether such condition is must under sec. 56(2)(x)?

Issues- Exception-Gift by individual to Private Trust

- Gift / Donations received by private trust (discretionary/specific trusts) settled by the individual for the benefit of individuals.
- Generally the relatives are to be looked from the view point of donee/recipient but in this exemption the relatives have to be checked from the view point of donor/giver/payer.
- Which of the following Donation/Gifts are covered by the exemption
 - Donations/Gifts received from the individuals/settlors by the trust created for the benefit of relatives of individuals only are covered under this exemption? Or
 - Donations received from all such individuals who are relatives of the settlor? Or
 - Donations received from the relatives of the beneficiary of the trusts? Or
 - All of the above?

Issues- Exception-Gift by individual to Private Trust (Contd.)

- Whether the trustee of any private or discretionary trust receiving any property/funds in the capacity of the trust are covered by sec 56(2)(x)?
- Terminations/ Closure of Private Discretionary Trust (PDT): Whether any sum of money received by the beneficiary on termination/closure of PDT is taxable under sec 56(2)(x)?

Ref: Ashok C. Pratap (Mum) and Mrs. Sharon Nayak (Bang)

Issues-Valuation

- Unquoted Shares: Shares which are not listed on registered stock exchange in India are unquoted shares.
 - Therefore, shares of foreign blue chip companies such as Microsoft, Facebook, Apple, Google are unquoted shares?
- Rule 11UA(1): To work out adjusted break-up value, Balance sheet to be drawn on date of transaction. Unlike 11UA(2) there is no provision to rely on the closest latest audited final accounts.
 - How to work out the FMV of Jewellery, Art work, unquoted shares and book value of other assets/liabilities if the transfer/transaction takes place in between the Financial year?

Issues-Valuation (Contd.)

- Date of valuation as per Rule 11U is the date on which the property or the consideration is received, whichever is earlier.
- Whereas as per Rule 11UAA, covering Sec.50C and Sec.50CA, is the date on which the property is transferred
- - Whether the intention is to have different amount of deemed income u/s 56(2)(viib)/56(2)(x) (Governed by Rule 11U) in the hands of the transferee and deemed income u/s 50C and 50CA in the hands of the transferor for the same transaction?

Issues-Capital asset received by/from the Partnership Firm/LLP

- Partner introducing his capital asset into partnership firm is covered by s.45(3)
- Whether the said capital asset received by the firm covered by s.56(2)(x) if such capital asset is transferred by the partner at the value lower than the FMV?
- Capital asset received by the partner upon dissolution / retirement s.45(4) provides that the capital asset transferred to partner upon dissolution / retirement is taxable in the hands of partnership firm by taking the value transferred at FMV.

Thank You!