The end of angel tax and its implications

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In its Union Budget for 2024-25, the central government, acknowledging the negative impact of angel tax on startup funding and investment, has announced its removal from the Indian tax system to encourage investment, promote entrepreneurship, and support innovation within the startup ecosystem. Given that this tax was introduced with a specific purpose, it is important to conceptually understand it and evaluate the impact of this budgetary change.

Concept: Angel tax was a direct tax levied on the excess amount of share premium over and above the fair market value ("FMV") of shares issued by unlisted companies (startups/established businesses) on raising capital from investors, known as angel investors. Angel tax was originally applied only to investments made by residents. However, the Finance Act 2023 broadened its scope to include non-resident investors as well. Although a subsequent notification in 2023 exempted few categories of investors from certain countries (subject to specific conditions), the proposed change still had the potential to affect foreign investments in India.

Purpose & Assessment: In India, angel tax was a relatively new concept which was introduced in 2012 by the then finance minister as a tax on "income from other sources" with the purpose of curbing money laundering through the undervaluation of shares and tracking shell companies. It was implemented under Section 56(2)(viib) of the Income Tax Act, 1961, with the FMV determined through Rules 11UA and 11UAA of the Income Tax Rules, 1962, added via amendments in 2012 and 2018. The tax rate was fixed at 30.9%. However, exceptions were made in the provision stating it to be non-applicable if the consideration for the issue of shares was received by a venture capital company, fund, or a class of investors notified by the Central Government. Further, evasion of angel tax attracted penalties for the companies in default.

Further Relaxations: Over time, it was observed that startups were losing a significant portion of their investment due to angel tax. As a result, in 2019, an exemption was introduced vide Notification no. Notification G.S.R 127 (E) dated 19.02.2019 ("Notification"), allowing startups to claim a 100% exemption from angel tax under Section 80-IAC of the Income-tax Act, 1961, provided they fulfilled specific criteria, including: (i) recognition by the Department for Promotion of Industry and Internal Trade (DPIIT); (ii) having aggregate amount of paid-up share capital/premium less than Rs. 25 crores (excluding funds raised from venture capital companies/funds and non-residents), after issuance of shares and (iii) having FMV evaluation done by a certified merchant banker.

The aforesaid Notification also provided the eligibility criteria for DPIIT's recognition/certification of a startup stating that an entity incorporated as a private limited company or registered as a partnership firm or a limited liability partnership would be considered as a startup up to 10 years from the date of its incorporation if the following conditions were met: (i) having turnover of less than Rs. 100 crores in any of the previous financial years; and (ii) working towards innovation/ improvement of existing products, services and processes and should have the potential to generate employment/ create wealth, except if formed by splitting up or reconstruction of an existing business. Additionally, the Notification also stipulated a 7-year restriction for the startups in terms of further investments.

Reason for Abolition: Despite the introduction of aforesaid exemptions/relaxations, investment levels remained low, adversely impacting the startup ecosystem and the broader economy. Additionally, it faced criticism for being overly stringent and burdensome, particularly for early-stage startups struggling to raise funds and finding investors. As a result, the central government decided to abolish angel tax for all classes of investors this year.

Impact of Abolition: Clause 23 of the Finance Bill, 2024 has proposed an amendment to the Income Tax Act, 1961, which will render the angel tax provision ineffective from April 1, 2025. However, the bill also provides that the said amendment will be deemed to have come into force on April 1, 2024. In the absence of any specific guidance/circular on whether this change will be applied retroactively, it can be said that the pending cases and investigations relating to angel tax violations/evasions initiated before April 1, 2024, will remain unaffected and proceedings will continue against such tax evaders/violators. Having said that, there is still a need for the central government to issue further clarificatory circular on this aspect and clear all ambiguities/doubts.

Way Forward: The removal of angel tax seems to be a positive step for encouraging more investments in startups and fostering a more supportive environment for entrepreneurial growth. However, this change raises serious concerns about the potential for black money generation through such investments. Thus, it is crucial to strike a balance between regulatory oversight on suspicious transactions and creating a favourable environment for startup growth by reducing financial/tax burden on them. The Authors are of the view that for ensuring transparency and preventing misuse, the government should issue a circular/notification that establishes an effective mechanism, requiring the recipient companies/startups receiving funds in exchange for shares to make immediate and mandatory declarations to a designated government authority, which can track the entire transaction, if required. Additionally, the use of these funds should be closely monitored to ensure that they are not diverted for illicit activities in or outside India. Implementing these measures will help maintain transparency, track suspicious transactions and ensure that investments remain legitimate, thereby mitigating the risk of money laundering/black money generation, which was the initial purpose of introducing angel tax in India. This purpose should not be ignored even after the end of angel tax era.