The Effects of the Angel Tax on the Indian Start-Up Ecosystem

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ABSTRACT

India is home to the world’s 3rd largest startup ecosystem and has produced a plethora of successful startups in the past decade, including Boat, Paytm, and Ola. However, the resurgence of the Angel Tax may hinder current growth and prevent India from reaching its goal of becoming the largest startup ecosystem in the world by 2030. This paper explores the questions: How will the tax affect start-up’s fund raising efforts? What is the current status of representations made by the various stakeholders who have raised genuine concerns on the amendment? Could there be ways to circumvent the hurdles that could impede genuine and legitimate growth in the start up ecosystem? Answering these questions is key to understanding how India’s economy will grow start-ups into world leading companies and as whole progress.

Introduction

The angel tax was first introduced by the Indian government in 2012 as a measure to reduce money laundering in the economy, as investing into immensely high valuations valuation start ups was one potential route adopted by resident investors to deploy unaccounted money (more commonly known as “Black Money”). As per the Income Tax Act, premium paid by an investor in excess of the FMV of the shares of the unlisted company will be taxable in the hands of the company at a rate of 30.9% thereby taxing any potential Black Money. The issue however was always the determination of the FMV.

Until 2023 however, this issue was limited to resident investors and the large global Venture Capitalists (VC) domiciled outside India were not impacted. As the latter formed bulk of the capital infusion into the Indian startup ecosystem, it did not impede funding thus far. The FA 2023 amendment though that also includes non-resident investors, can be a serious deterrent to India’s growth.

Theory

Previous Angel Tax Structure

This is not the first time the Angel Tax is being brought to India, as it was first introduced in 2012. Back then, in order to be obliged to pay the Angel Tax, a company had to be registered under one of three acts: 1.) Companies Act 2013, 2.) Partnership Act 1932, or 3.) Limited Liabilities Partnership Act 2008. Additionally, the company had to be less than seven years old and have a turnover of less than 25 crore rupees ($3.4 million). To determine the levy amount, the government compared the fair market value (FMV), calculated using a Net Asset Value (NAV) model, with the valuation provided by the angel investor. Whatever additional cash was provided by the Angel Investor would be considered as 'Other Incomes,' and a 30.9% tax rate was levied. However, the tax could be avoided if the investment value was below 10 crore rupees ($1.2 million) or if the net worth of the investor fell below 2 crore rupees ($250
thousand), therefore, sparing smaller local investors. The purpose of the tax at the time was primarily to prevent money laundering and hence targeted larger domestic investors. That said, as Indian start-ups grew, the government decided to begin providing relief to many start-ups from the Angel Tax in 2019, as the government wanted start-ups to capitalize in the bullish sentiment on the Indian market overall. [CBDT 2012]

Current Angel Tax Structure

In the 2023-24 budget announcement, the Indian Government reintroduced the tax with multiple new conditions. Most notably, foreign investors are now potentially liable to pay the angel tax. However, certain foreign investors are still exempt from the angel tax, including any entity that is 75% or more owned by the government, banks, other regulated entities in insurance, endowment funds, pension funds, or any Category-1 Foreign Investor registered with the SEBI. Moreover, investors from 21 countries have been exempt from this tax including the US, UK and much of Western Europe while countries such as Singapore, the Netherlands and the UAE, areas from which most of India’s FDI come from have been left unexempt. Furthermore, the range of valuation methods to be used to find the FMV has been extended to 5 for non-resident investors. Moreover, a safety harbor of 10% has been provided to Start-Ups as forex fluctuations, bidding fees, and duty may cause variance in the final invested amount. [CBDT 2023]

Literature Review

The potential effects of the angel tax are difficult to predict and there are 2 main academic studies which comprehensively analyze the effects. First the work of Jain S. and Mathur et al. which was published recently in the SSRN and takes a generalist approach looking at the angel tax from all perspectives of not only the investors and investees but also the government. The second study is published by Sudhakar Bokephode et. al. and focuses on the start-ups perspective and what it will mean to them, providing recommendations to reduce issues for them. These are the primary hypothesis presented in the studies:

**Hypothesis 1**: Investors see the tax as being overly hostile to start-ups [Jain, S. and Mathur et al. 2023]  
Start-ups are notoriously hard to value as they lack historical financial information. Therefore, their valuation is highly subjective, and using models such as DCF and NAV becomes extremely inaccurate. Even with up to 5 valuation methods available, the difference between the FMV and invested amount will always be there, as sticking to stringent numerical models will almost always undervalue start-ups, especially those in the seed stage.

**Hypothesis 2**: Investors could ask start-ups to relocate outside India [Jain, S. and Mathur et al. 2023]  
As stated above, investors registered with the SEBI will be exempt from the angel tax. However, the number of investors registered is only 1052, and only between 10%-15% of these fund start-ups. As a result, instead of the investors increasing their regulatory risk and coming under the purview of the SEBI, they may ask the start-ups to relocate to areas where they and the start-up can enjoy better tax benefits, eventually causing the size of the Indian start-up ecosystem to shrink.

**Hypothesis 3**: Assessing officers should accept valuations and ask questions along the way rather than ask for a FMV [Sudhakar Bokephode et. al.]  
Start-ups which are asset light and are in seed stage will be impacted hardest as their valuations are mainly based on forward-looking projections and take into account goodwill, IP, market potential and disruptive ideation which are to factor into valuation models and justify. Therefore the assessing bodies should accept the initial valuation and apply the tax on a case by case basis.
Methodology

This research is a survey study employing qualitative methodologies, and the rationale for this method is to gather data from an exclusive and expertised participant group with different backgrounds, thus reducing the biases that might exist within the sample, in the meantime it would also allow for a more free-form and open discussion as the tax is still not even fully implemented yet, therefore quantitative results on the potential effects would be hard to gather, as we aim to gain a grasp on sentiment first and then formulate hypotheses of potential effects.

1. What do you believe is the Primary Objective of the Angel Tax and its most recent 2023 proposed amendment?

2. Besides DCF & NAV, five additional valuation methods provided under Draft Rule 11UA for Non-residents have been proposed (Aligning with FEMA), Comparable Company Multiple Method; Probability Weighted Expected Return Method; Option Pricing Method; Milestone Analysis Method; Replacement Cost Methods. Would these additional methodologies help with solving the biggest concern raised by the investors and investees? i.e. Establishing Fair Market Value (FMV) for a start up and therefore the tax payable on the premium?

3. Exemption from Angel Tax has been extended to 'notified entities' from 'Specified Nations' have now been proposed, but notably the following countries are missing from the list. Which of these countries must be included in the next amendment should the CBDT be forthcoming?

4. In addition to the concessions made above, between Feb 23 and June 23 CBDT has made further allowances that are in favor of the investors as well as the investees:
   - Price matching for resident investors;
   - Safe harbor for both resident and non-resident investors;
   - 90 days now specified as the time period for validity of valuation report, and DPIIT registration.
   Are these now going far enough to mitigate the adverse impacts or is the Angel Tax still a big threat to the ecosystem?

5. What are the top concerns still needing to be addressed for the tax?

Population, Sampling, Data Collection, and Analysis

The population consists of Angel Investors and Chartered Accountants. The survey was conducted in the form of an interview & questionnaire and aimed to piece together a holistic perspective on the general sentiment of the market about the tax. While the conversations mainly stayed on the lines of the above questions, some stakeholders were asked more specific questions which will be discussed below.

Findings

Investor Perspective 1

While conversing with Mr. Rajat Aggarwal, Managing Director of Matrix Partners, one of India’s largest venture capital funds, it became evident that he believes the primary objective of this tax is to prevent money laundering and the channeling of funds through foreign shell companies. When queried about the inclusion of the new valuation methodologies, he acknowledged that while their addition is a step in the right direction, they do not resolve the
concerns of the government or investors. As valuation is not an exact science, merchant bankers could utilize these models to easily present favorable valuations to investors. Although the government might scrutinize these valuations, it creates an additional administrative cost for start-ups as they are compelled to address government inquiries, consuming valuable time.

In response to the question about adding countries to the exemption list, Rajat concurred that Mauritius, Netherlands, and the UAE should be appended to the list. These countries serve as the major sources of funds for India, contributing over 50% to India’s Foreign Direct Investment (FDI). Additionally, countries like Mauritius have been adhering to anti-corruption guidelines for the past few years.

When the subject of the “safety harbor” was raised, he opined that while it is beneficial to have, its primary purpose is to save time rather than maximize funds raised. Nevertheless, it would not effectively mitigate the issue of variance in valuations, given that start-up valuation is not an exact science. Lastly, when asked about the top concerns still needing to be addressed about the tax he raised particular concern to the subjectivity of FMV determination as before, the litigation cost from scrutiny by the government as well as a specific challenge for loss making start-ups such as those with a long in the very early stage of development, as their valuations will be hard to justify.

When asked about the potential work-arounds that may arise, start-up India i.e. DIPT registration of the start-up emerged as the best option to him as it costs only 7,499 rupees and will allow start-ups to remain stations in India.

Investor Perspective 2

Upon asking the following questions to representatives at 1. Sauce VC, a food and beverage specialized fund 2. Enzia, an education and healthcare specialized fund 3. Leeu Collection, hospitality specialized investors, we received the following responses to the questions above.

For question 5. Above the following options were provided

a. No clarity on treatment of Preference shares and convertible instruments
b. Investors must have tax-efficient exit options- FEMA Regulations require investment above FMV but tax regulations tax excess
c. FMV will always be a number that will be disputed
d. Fear of Tax Scrutiny on valuation (plus tax litigation cost)
e. Unreasonable Tax Demands from start-ups already cash strapped
f. For loss making Start-ups – Angel Tax will always be a challenge
Besides DCF & NAV, five additional valuation methods provided under Draft Rule 11UA for Non-residents have been proposed (Aligning with F... up and therefore the tax payable on the premium

3 responses

Exemption from Angel Tax has been extended to 'notified entities' from 'Specified Nations' have now been proposed, but notably the following countries... next amendment should the CBDT be forthcoming?

3 responses

In addition to the concessions made above, between Feb'23 and June'23 CBDT has made further allowances that are in favour of the investors as well... the Angel Tax still a big threat to the ecosystem?

3 responses

What are the top 3 concerns still needing to be addressed for the investors and investees? (select any 3)

3 responses
Accountant Perspective

After interviewing Mr. Sandeep Singh, the founder of SKS Advisors, who serves as an accounts advisor to 100+ startups in India, he suggested that the angel tax serves two main purposes. Firstly, it prevents money laundering through shell companies registered abroad. Secondly, it creates a new avenue to generate tax revenue, as many startups in India are able to avoid paying existing taxes, such as corporate tax.

When asked about the addition of the new valuation methods, he remarked that some of these Fair Market Value (FMV) determination methods had already been used prior to the announcement in special cases. Their official addition will now help in proving valuation more effectively.

In response to the query regarding the main concerns that still need to be addressed, he immediately pointed out that in the context of an emerging economy such as India, where the startup culture has only picked up in the past few years, this move is very hostile and has a significant psychological effect. It directly combats campaigns such as Start-Up India.

Lastly, when asked about the workarounds to the tax and the possible final implications that may be seen, Sandeep was quick to point out that a very real and detrimental consequence would be startups relocating outside India to countries such as Estonia, the USA, and Korea. He himself has helped many startups register outside India and sees it as a very viable option for startups to avoid stunting growth.

Conclusions

Upon conversing with all stakeholders, it was clear that none of them expressed particular support for the tax; instead, they mostly offered critiques. It was described as an unnecessary measure that would hinder the growth of startups, rather than an effective means to prevent money laundering, as it could lead to alternative methods of money laundering being utilized.

Based on the evidence, the following effects can be observed:

1. **Start-ups Choosing to Register in Countries Like Estonia and New Zealand:**

   This effect aligns with the hypothesis of Jain, S. and Mathur et al., as DIIPT registration is extremely uncommon in India, with only 1% of the total number of start-ups in India registering [Ministry of Commerce and Industry]. This is primarily due to the cumbersome and time-consuming registration process, as well as the fact that the support provided is only available in select regions. Start-ups may see no tangible benefit for registration and would instead opt for other schemes provided by local state governments.

   Furthermore, the trend of registration in countries like Estonia and New Zealand is not unique to Indian start-ups; it is a global phenomenon. Estonia offers a range of benefits, such as a 0% corporate tax on income not distributed as dividends, a robust digital infrastructure, and, most importantly, a supportive ecosystem with access to government grants, VC funding, and no angel tax [Department of Economic Affairs - Estonia]. New Zealand offers a robust legal framework that strongly favors start-ups in funding contracts, as well as access to global markets through agreements with other countries. These nations are well-positioned to fill the gaps in the Indian market and are, therefore, an attractive option for reducing Indian start-ups' exposure to regulatory risk [Ministry of Business, Innovation and Employment].

   However, the Indian government is taking steps to prevent this from happening, including the opening of GIFT City in Gujarat. GIFT City offers a 10-year tax holiday, a competitive digital infrastructure, and a network of VCs and angels not subject to the Angel tax. Although GIFT City has only attracted $102 million
in investment so far [Incorp], whether this will be enough to replace the void left by Mauritius, the Netherlands, and Singapore remains to be seen. However, there are positive indications, with National Investment and Infrastructure Fund (NIIF), Kotak Investments, Blume Ventures, 3one4 Capital, ICICI Ventures, and HDFC Capital already registering in GIFT [Business Line], suggesting that domestic investors are ready to invest.

2. **Government Choosing to Combat a Bubble in the Indian Start-up Ecosystem:**

While preventing money laundering is a primary objective, using the Angel tax for this purpose seems unusual, as it negatively impacts the start-up ecosystem. There are other equally effective ways to prevent money laundering through excess share premium, including reinforcing current KYC procedures and implementing simple transaction monitoring. This raises the question of why the government would choose to target start-ups in the process.

This likely stems from the common belief that the ecosystem is in a bubble, with over 55% of investors believing Indian start-ups are overvalued [Trackxn]. Consequently, the government imposing a substantial tax on other incomes of a company can help reduce valuations produced by investors. Moreover, it will limit the availability of funds, creating a survival-of-the-fittest scenario where only start-ups with long runways and profitability will survive.

Furthermore, the announcement in 2023 comes at a time when many of India's largest start-ups are facing challenges. For example, Byju's, which once boasted a $22 billion valuation, is still facing losses that exceed its revenue by 20 times [Business Today]. Additionally, companies like Zomato, which is barely breaking even, and Swiggy, which has attracted $545 million in funding [CNBC], still have valuations of $9.22 billion and $5.5 billion, respectively [Company Market Cap Net]. This suggests that the government may also be trying to address the issue of overvaluation in the start-up ecosystem.

**Limitations**

The angel tax, despite being around since 2012, still has very little public knowledge, making it challenging to find qualified individuals with opinions on the tax. Therefore, for future studies, I would recommend gathering opinions from investors in various industries, not just the ones mentioned above. Additionally, it would be beneficial to directly obtain the opinions of startup founders rather than relying on accountants as intermediaries. In this study, when approaching startup founders, they expressed a lack of knowledge and expertise regarding the tax, often referring us to their accountants. In the future, as the new version of the tax becomes more widely implemented, it is hoped that more founders will possess the knowledge and expertise necessary to better assess the tax’s impact.

**References**


