

Angel Tax & Start-Ups in India

written by iasexam.com | 04/02/2023



Context- Recently, The Finance Bill, 2023 has proposed to amend the Section of the Income Tax Act which might affect Start-Ups funding in India.

Key Highlights

- The Finance Bill, 2023 has proposed to amend **Section 56(2) VII B of Income Tax Act**.
- These new age firms, which offer their shares to foreign investors, may have to pay 'angel tax', that was earlier only supposed to be paid for investments raised by resident Indian investors.

Angel Tax:

- Angel tax is a term particularly used to refer to the income tax payable on capital raised by unlisted companies via the issue of shares where the share price is seen in excess of the fair market value of the shares sold.
- The excess realisation is treated as income and taxed.

Original provision:

- Section 56(2) VII B of the Income Tax Act, also known as the 'angel tax' was first introduced in 2012.
- The provision states that,
 - when an unlisted company, as a start-up, receives equity investment from a resident for issue of shares that exceeds the face value of such shares, it will be counted as income for the start-up and be subject to income tax

under the head 'Income from other Sources' for the relevant financial year.

- **Significance of provision:**

- The provision aims to deter the generation and use of unaccounted money through the subscription of shares of a closely held company at a value which is higher than the fair market value of the firm's shares.

Changes by the Finance Bill, 2023

- With the latest amendment, the government has proposed to include foreign investors in the ambit, meaning that when a start-up raises funding from a foreign investor, that too will now be counted as income and be taxable.
- For instance, if the fair market value of a start-up share is Rs 10 apiece, and in a subsequent funding round they offer it to an investor for Rs 20, then the difference of Rs 10 would be taxed as income.

Challenges

- **Role of foreign investors in India's start-ups:**

- Foreign investors are a key source of funding for start-ups and they have played a big role in increasing their valuation.
- For example, Tiger Global, one of the most prolific foreign investors in India, has invested in over a third of the start-ups that have turned unicorn, with a valuation of at least \$1 billion.
- Unicorns are privately held, venture-capital-backed startups which have reached a value of \$1 billion.

- **Lacking funds:**

- The move could negatively impact financing available to the start-ups, which have already been reeling under a funding winter since 2022, industry insiders are speculating.
- The change comes as the funding for India's startups dropped by 33 percent to \$24 billion in 2022 as compared to the past year.

- **May repel foreign investors:**

- It could compel more startups to flip overseas, as foreign investors may not want to deal with additional tax liability by virtue of their investment in the startup.

Start-up ecosystem in India

- India has the 3rd largest startup ecosystem in the world; expected to witness year on year growth of consistent annual growth of 12-15%.
- The pace of growth in the startup ecosystem has grown to 15% year-on-year in 2018, while the growth of the number of incubators and accelerators has grown to 11%
- The Indian startups have gone on to increase sizable ticket sizes from various global and domestic funds.

Role of Women:

- Also, the number of women entrepreneurs stood at 14%, up from 10% and 11% in the previous two years (2021-22).

India's startup city:

- Bangalore has been listed within the world's 20 leading startup cities in the **2019 Startup Genome Project ranking**.
- It is ranked as one of the world's five fastest growing startup cities.

Government's initiatives to promote Start-ups in India:

Startup India Initiative:

- Since the launch of the initiative in January 2016, over 69,000 startups have been recognized in the country till May 2022.
- **Sectors:**
 - They were launched across 56 diverse sectors, such as
 - 13% from IT services,
 - 9% from health and life sciences,
 - 7% from education,
 - 5% from professional and commercial services,
 - 5% from agriculture, and
 - 5% food and beverage.
- **Functions:**
 - Enhanced infrastructure with incubation centers.
 - Easier IPR facilitation, with easier patent filing
 - A better regulatory environment including tax benefits, easier compliance, improved setting up a company, faster exit mechanisms etc.
 - An economic stimulus in the form of a INR 10,000 crore Fund of Funds managed by SIDBI, with the target of increasing funding opportunities.
- **Government Data:**
 - As per data from the Ministry of Commerce and Industry, the number of people employed in start-ups covered under the Start-up India initiative arr about 1.74 lakh in 2021.

Start-Up India Programme:

- A flagship initiative, intended to build a strong eco-system for nurturing innovation and start-ups in the country in order to drive sustainable economic growth and generate large scale employment opportunities.

Start-up India Digital Platform:

- It is the world's largest virtual incubator with more than 300,000 registered start-ups and aspiring entrepreneurs.

Start-up Grand Challenge:

- It channelizes the entrepreneurial capacity between Indian and Korean start-ups in order to work together and build solutions for the challenges facing the world.