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CA Dr. Gopal Krishna Raju, a Chartered Accountant, Insolvency Professional, Registered Valuer & Arbitrator with over 26 years of experience. He is also a visiting faculty at the Indian Institute of Management & Indian Institute of Corporate Affairs. Also Known as the "Rajnikant of Valuation" among peers.

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ANGEL TAX - IT RULES FOR VALUING INVESTMENTS IN STARTUPS

CBDT NOTIFIES CHANGES TO RULE 11UA(2) IN RESPECT OF ANGEL TAX

Finance Act, 2023, brought in an amendment to bring the consideration received from non-residents for the issue of shares by an unlisted company within the ambit of section 56(2)(viib) of the Income-tax Act, 1961, which provides that if such consideration for issue of shares exceeds the Fair Market Value(FMV) of the shares, it shall be chargeable to income-tax to the issuer company under the head 'Income from other sources'.

Draft Valuation Rules: Keeping in line with the commitment of the Government to involve stakeholders in the drafting of the law, suggestions and feedback were invited from stakeholders and the general public on Draft Rule 11UA(2) for the valuation of methods for calculating the Fair Market Value {vide Press Release dated 19th May 2023}

Considering the suggestions received in this regard and detailed interactions held with stakeholders, Rule 11UA for the valuation of shares for the purposes of section 56(2)(viib) of the Act has been modified vide notification no. 81/2023 dated 25th September 2023.

The key highlights of the changes in Rule 11UA(2) are:

a) In addition to the two methods for the valuation of shares, namely, Discounted Cash Flow (DCF) and Net Asset Value (NAV) method, available to residents under Rule 11UA, five more valuation methods have been made available for non-resident investors, namely, Comparable Company Multiple Method (CCM), Probability Weighted Expected Return Method (PWERM), Option Pricing Method (OPM), Milestone Analysis Method (MAM), Replacement Cost Method (RCM).

b) Where any consideration is received for issue of shares from any non-resident entity notified by the Central Govt., the price of the equity shares corresponding to such consideration may be taken as the FMV of the equity shares for 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 company from the notified entity within a period of ninety days before or after the date of issue of shares which are the subject matter of valuation.

c) **Benchmarking price:** On similar lines, price matching for resident and non-resident investors would be available with reference to investment by Venture Capital Funds or Specified Funds.

d) **CCPS Valuation methods in sync with Equity Valuation methods:** Valuation methods for calculating the FMV of Compulsorily Convertible Preference Shares(CCPS) have also been provided.

e) **Safe harbour limit introduced:** Further, the price at which shares are issued is higher than the value determined per Rule 11UA, by not more than 10%, the issue price will be held as the FMV. This would take into account the foreign fluctuations, bidding processes and variations in other economic indicators, etc. which may affect the valuation of the unquoted shares.

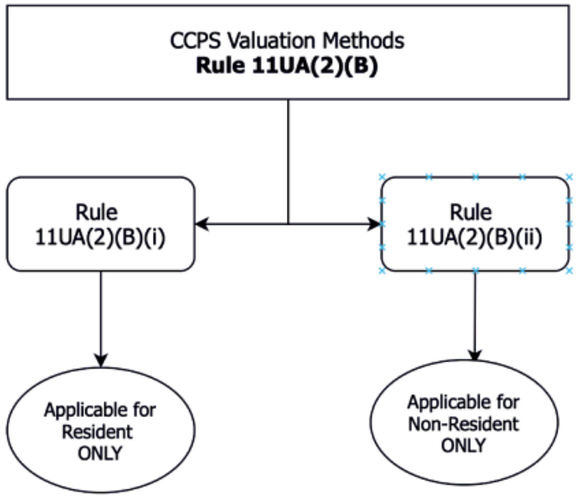
f) **Merchant Banker report to not be older than 90 days:** It has also been proposed that the valuation report by the Merchant Banker would be acceptable if it is of a date not more than 90 days prior to the date of issue of shares which are the subject matter of valuation.

g) **Broad Parity:** The notified Rule provides for expansion of the valuation methodologies to include globally accepted methodology and provide a broad parity to resident and non-resident investors.

H) **At the option of the assessee:** The new rules have given multiple options to the assessee, scope for valuers to explore, and comfort for investors to choose. In NINE places the words at the option of the assessee have been used for the first time in the history of the Income Tax Act.

VALUATION METHODS FOR NON-RESIDENTS

Mathematical Models / Scenario Analysis: Unlike derivatives and debt markets, mathematical option pricing models have not seen wide usage in the Private



Capital marketplace. Such models are rarely used by Market Participants to determine the transaction price for an Investment. However, for certain early-stage Investments, option pricing models (OPM) or probability-weighted expected return models (PWERM) are deemed by some to provide a reliable indication of Fair Value where a limited number of discrete outcomes can be expected.

To the extent a Market Participant would determine the value of early-stage Enterprises using mathematical models or a scenario analysis, it would be appropriate to consider such Valuation Techniques in determining Fair Value. For example, Enterprise Value could be estimated by assigning probabilities to value increasing (future up round), value remaining the same (flat round), value decreasing (down round), and value eroding (zero return), taking into account anticipated dilution, if any, and then discounting the future funding event to the Measurement Date using an appropriate weighted average cost of capital. The Enterprise Value could then be allocated, again using estimated probabilities, to individual securities using a liquidation or exit approach meaningful for each scenario. It should be noted that selecting inputs for such techniques would be highly subjective.

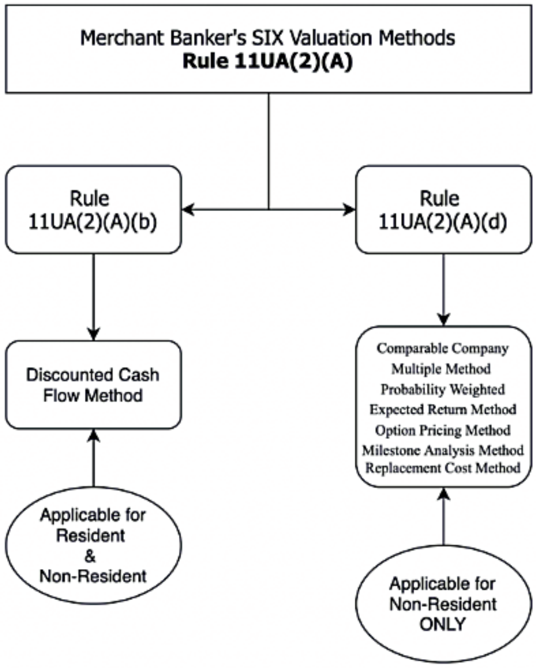
Valuing seed, start-up, and early-stage (pre-revenue/pre-earnings) Investments: Many seed, start-up, or early-stage Investments are valued using a milestone approach, or scenario analysis because there are no current and no short-term future earnings or positive cash flows. For these Enterprises, typically, it is difficult to gauge the probability and financial impact of the success or failure of development or research activities and to make reliable cash flow forecasts.

Consequently, the most appropriate approach to measure Fair Value may be a Valuation Technique that is based on market data and Market Participant assumptions as to the potential outcomes. Calibrating such scenarios or milestones may result in a Fair Value equal to the transaction value for a limited period of time. Often qualitative milestones provide a directional indication of the movement of Fair Value.

The following valuation techniques may be helpful in estimating Fair Value:

- scenario-based methods, a forward-looking method that considers one or more possible future scenarios. These methods include simplified scenario analysis and relative value scenario analysis, which tie to the fully diluted ("post-money") equity value, as well as full scenario analysis, also known as the probability-weighted expected return method (PWERM);
- the option pricing method (OPM), a forward-looking method that considers the current equity value and then allocates that value to the various classes of equity considering a continuous distribution of outcomes, rather than focusing on distinct future scenarios;

Replacement Cost Method: Replacement cost valuation is a method of estimating the value of an asset by determining how much it would cost to acquire or reproduce it in the current market. This approach is often used for tangible assets with no active or liquid market, such as real estate, machinery, or inventory. However, using replacement cost valuation in dynamic and uncertain markets can pose several challenges and risks for business owners, investors, and appraisers.



CONCLUSION

The inclusion of a tolerance threshold for minor valuation discrepancies further enhances efficiency and fairness in tax assessments, ultimately benefiting both taxpayers and the government. These changes offer taxpayers a broader range of valuation methods to choose from, including internationally recognized approaches, thereby attracting foreign investments and fostering clarity.