As valuations plunge, startups asked to shell out more in tax

By *Sachin Dave* & *Vishal Dutta*, ET Bureau | Updated: Dec 26, 2016, 01.09 AM IST

MUMBAI | AHMEDABAD: Startups that have seen marked down valuations in subsequent funding rounds have been ordered to pay tax on the grounds that the first round of investment was made at a premium.

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The Income Tax department has issued such orders or adjustments in about 100 cases across India between November 30 and December 15, according to people in the know.

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Startups that have received the tax demand will have to cough up 33% tax on the premium by March 31 or challenge the order in the court of law. The tax demand is made for the assessment year 2013-14 and 2014-15 in almost all the cases. But, according to industry experts, most startups won't take legal recourse. They will choose to focus on their business than going into litigation."

"In most of the cases, the valuation in the angel or seed round runs ahead of fundamentals and is based on the longterm promise a startup presents, which, in the majority of the cases, does not materialise. Tax officers are disputing the valuations by either comparing the projections/assumptions done during the valuation round with the actual performance later (which in many cases is below the projections) or taking the valuation of the subsequent round as the base to prove that the valuation in question is unreasonable.

These firms are then issued notices under the Section 56(2)(viib) of the Income-tax Act, 1961," said Amit Maheshwari, Partner, Ashok Maheshwary & Associates.

"Any consideration received by a company (startup) from a resident against the issue of shares exceeds the fair market value of such shares, such excess consideration is taxable in the hands of the startup as income" reads the Section 56(2)(viib) of the Income-tax Act, 1961.

Many tax officials believe that the Section gives them the power to levy tax on the excess consideration more than the fair value against issue of shares. There is also a view among many tax officials that startups should be valued on the basis of the last round of investment. The problem is magnified, as in recent times valuations of many startups have fallen sharply on worries over profitability, growth and intense competition.

"I can only say it's harassment for entrepreneurs & investors equally," said Sanjay Mehta, a well-known angel investor whose portfolio of 63 startups include Oyo Rooms, Poncho.in and Talview. "This whole exercise will not yield any additional taxes (revenue) for IT department but it will surely impact the morale of entrepreneurs and ease of doing business," said Mehta. About five startups from his portfolio have received the tax demand, he said.

Tax demand is mainly made on domestic startups that have received investment from Indian investors or venture capital funds not registered with The Securities and Exchange Board of India (Sebi).

ET had on June 2 written that startups with marked down valuations may face tax notices. After which CBDT on June 14 had issued a notification and said that no such tax will be levied on startups that register with the government. In one of the cases, a tax demand was made on a startup that had got three rounds of investments. In the first round, a group of angel investors invested in the startup at 10 times its valuation. But the second round of investment from a VC was made at six times the valuation of the startup.

In this particular case, the income tax department is disputing the valuation of the company and have come to a conclusion that the angel investor had paid a premium and tax needs to be paid on that.

