The Startup Tax

Why startups and early stage investors must worry

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Budget 2012 introduces a potential time bomb for startups looking for funding. An investment in any private company could be classified as "income" unless they can justify the valuation to a tax officer.

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Introduction

An innocuous clause in Budget 2012 is a **potential time bomb for startups** looking for funding. An investment in **any** private company could be classified as "income" unless they can justify the valuation to a tax officer. If they fail to do that, the startup will pay tax on the investment.

We'll explore what this new clause is, and how it impacts startups. And then, what you can do to protest, and known work-arounds.

What's the problem?

Look at the Budget "Memorandum" under section "**Share premium in excess of the fair market value to be treated as income**" (Page 8).

> It is proposed to insert a new clause in section 56(2). The new clause will apply where a company, **not being a company in which the public are substantially interested**, receives, in any previous year, from any person being a **resident**, any consideration for **issue of shares**. In such a case if the consideration received for issue of shares exceeds the **face value** of such shares, the aggregate consideration received for such shares as exceeds the **fair market value** of the shares shall be **chargeable to income tax** under the head "Income from other sources. However, this provision shall not apply where the consideration for issue of shares is received by a venture capital undertaking from a venture capital company or a venture capital fund.

Let's look at things from a startup angle:

- That the public is **not substantially interested** means unlisted companies, which is what startups usually are.
- Getting investment from **residents**: Angels are usually Indian resident individuals or companies.
- Investment at **higher than face value**: Most startup funding will qualify. I'll explain.

How Do Startups Get Involved?

A startup gets funding from a seed or angel investor in exchange for equity. The valuation at the time is usually based on an idea, with very little else to support it. A startup can be two people working out of a garage, or nowadays, out of home or coffee shops; no assets, very little money. Long on potential, short on navy blue suits.

When a company is created, shares are issued to the initial investors at "par" or at face value, in proportion to their investment. For example, take a company started with 100,000 rupees (one lakh rupees), with two founders putting in Rs. 60,000 and Rs. 40,000. Each will get 6,000 and 4,000 will get shares of Rs. 10 face value, respectively, for a total of 10,000 shares.

Founder 1: 6,000 shares (60% of company)
Founder 2: 4,000 shares (40% of company)

The founders work for **6 months** and build a prototype for a software to revolutionize online payments. They demonstrate this, with a business plan, to an angel investor, showing how similar companies have made enormous sums of money. They then ask for **Rs. 20 lakh as an investment** to hire people, buy some equipment and for marketing.

At this point, the software company has nothing but a prototype. It might have talked to customers, identified people to hire, earmarked funds for purchases if they got the money. It has **spent nearly 75,000** of the one lakh rupees the founders put in, on paying rent on a small office, travelling to meet prospective customers, and designing their web site. How do you value this company?

Do you say the value of the company is whatever is left in the bank account? That's just Rs. 25,000 or Rs. 2.5 per share. That is ridiculous, but this is what the company really owns – there's just an idea, which has little "accounting" value. Now no one would agree with this method – obviously some work has gone in creating that prototype!

Let's be nice and say that the original valuation of Rs. 100,000 remains. So we'll value the company at Rs. 10 per share, or at "**par**".

A fresh investment by an Angel of Rs. 20 lakhs (2 million) at Rs. 10 per share (face value) will mean giving the new investor 200,000 shares. The equation is:

Founders: 10,000 shares (together)
Investor: 200,000 shares (new)

After the investment, the **investor will own 95% of the company**, and the founders a **miserable 5%.** Will they be motivated to work further? Without a reasonable stake, and with low salaries? (Startups must scrounge to conserve cash, and founder salaries are very low. Angels also balk at providing market salaries to founders.)

You can then expect the founders to start submitting their resume for a job. **Why bother with a startup with nearly no stake and low salaries?**

The answer, then, is to provide an incentive in the form of a **higher stake for founders**. In the case above, the angel might understand that the founders have worked hard to create a prototype, and have validated much of the idea by getting early interest from customers. That de-risks the venture, and so the value of the startup is higher than just an idea. Based on the angel's own knowledge of the industry or connections, the startup might, in his opinion, be worth Rs. 400 crores in 10 years. He might value the startup at, say, Rs. 40 lakh (4 million) today. On a per-share basis, that is Rs. 400 per share. For his Rs. 20 lakhs, he gets an additional 5,000 shares. So the equation is:

Founders: 10,000 shares. (67%)
Investor: 5,000 shares. (33%)

The founders together own 67% of the company, while the angel investor owns 33%. This leaves enough for founders to stay motivated, knowing perhaps that they may get diluted further in few rounds of venture capital financing, which will only happen when they see revenues. A far more equitable distribution and a "win-win" for everyone involved.

The investment was done at "**higher than par**" value: the Rs. 10 par value share was bought by the angel investor for Rs. 400.

This is the most common way service or software statups are financed, because a large part of their value is intangible, a forward premium on what the investor believes they can achieve.

Understood. What's the problem with the tax clause?

The finance bill intends to tax such "**higher than par**" or "**premium**" valuations, if the value isn't justifiable.

That means, if the tax officer doesn't understand why you were valued at Rs. 400 per share, and he thinks you should only have gotten Rs. 10 per share, you'll be taxed on the Rs. 390 extra.

The clause says:

> Further, it is also proposed to provide the company an opportunity to substantiate its claim regarding the fair market value. Accordingly, it is proposed that the fair market value of the shares shall be the higher of the value—
> (i) as may be determined in accordance with the method as may be prescribed; or
>
> (ii) as may be substantiated by the company **to the satisfaction of the Assessing Officer**, based on the **value of its assets**, including intangible assets, being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature.

You've spent all that time convincing an angel investor, now you can spend some more time convincing an Assessing Officer that your idea is an "asset" that is valuable enough.

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Startups hardly have any assets worth speaking about. Most of the valuation is the potential of the idea, and the confidence in the founding team. These aren't classified as assets in the tax parlance.

Why This Change?

There is a potential tax hole in a situation where;

- I want to pay your company some money: say Rs. 20,00,000 (20 lakh).
- If I do the normal thing, I will have to pay service tax on your invoice, and then you will have to pay income tax on the money you get from me (post your expenses).
- Instead, you give me one share in your company – just one share – for that 20 lakh. I will get a microscopic ownership in your company which I don't care about. You will get the money "tax free", as an investment. You can then use it as you wish.

Sure, such situations exist. But they must be the tiny minority. Like @tejus_sawjiani said: *It's like gassing a room to kill a mosquito.*

A startup that receives a "premium" on its face value now needs to justify its valuation to a tax officer, who will use specific measures to value it, and those measures **only include the sum of the value of its assets**.

Note: There are potentially other forms of valuation that may be acceptable. Unfortunately, with no clarity, we can't assume much about them.

If the valuation is not acceptable, the investment will be treated as income, and therefore, the income will be taxed. **It's like making your investor your customer instead.**

This serves a death knell to early stage investing, especially in the technology sector where valuations are based on very hazy numbers by founders. Who knew the potential of yet-another-search-provider when Google started?

Some Early Stage Stories

Andy Bechtolsheim funded **Google** with $100,000 for yet another search engine, whose relevance or valuation would have been lost on most tax officers of that time, had this rule been applied in the US.

Peter Thiel funded **Paypal's** co-founder **Max Levchin** to implement cryptography libraries on handheld devices. Only later did they move to electronic payments. Imagine Thiel and Levchin having to explain to a tax officer how to value an idea for a crypto-library on a Palm pilot.

Paul Graham of **YCombinator** fame rejected an offer from early investors for a small sum of money, because they wanted a majority stake for it. They later were funded $100,000 for their "online store builder" called Viaweb which was acquired by Yahoo later.

Mena and Ben Trott's Six Apart hadn't even started **Typepad** when they got funding from Joi Ito's Neoteny.

(Much of the above is from "Founders at Work", by Jessica Livingston)

Back home, **Mobstac** raised funds for a mobile startup based on hard work for two weeks. You and I might know this is substantial effort, but to a tax officer it's two weeks of work.

Some of the early funded startup stories aren't yet successful; others are wildly profitable or have been sold for a huge amount of money. It's difficult enough for investors who know the field to not miss big opportunities. It will be much more difficult to find a tax officer that gives any of the above startup valuations a thumbs up.

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Workarounds

For Founders

If you're a **founder**, you can try a milestone based approach where each milestone will involve a valuation that can be justified (although I have little faith in a tax assessing officer's ability to understand startup valuation based on implementation).

The other method is to use **convertible debentures** or **compulsorily convertible preference shares**. Here you take on the investment as debt, and as time goes by it converts into equity at a potentially fixed rate. At the time of conversion, the valuation may be more apparent and justifiable. In reality, much of such conversion might only happen when a Venture capital firm has decided to invest at a higher valuation. The downside: convertible debt will involve an interest payout; the

Another is to use a **sweat equity** approach. Say you give the investor shares at "face value", and allocate yourself "stock options" that vest over the next two years, and give you additional shares equivalent to 90% of the company. This introduces the problem that you have been given stock worth a large sum, for no consideration – is this not taxable as income under stock option norms?

A startup could consider **going abroad**. The idea will be to create a foreign entity, in Mauritius or a tax-friendly country, and have that company create a subsidiary in India. All investment goes into the foreign company, and Indians can invest upto $200,000 per year abroad. However, the new General Anti Avoidance Rules and the increased scrutiny of Indians who own assets abroad may create more problems that this method solves. I mention some other disadvantages in the FAQ section.

Since the law applies only to investment into companies, you might be able to start a **Limited Liability Partnership** where there is no concept of "shares". Later when you are ready for a VC fund you can create a company and transition assets. Note however that transferring assets like knowledge or money which can be removed and reinvested, is easy. Transferring real assets like property and even tables and chairs will involve stamp duty and/or capital gains taxes which can be expensive. But for service oriented startups which don't have too many assets, this may be an avenue to consider.

Finally, just find a **non-resident angel investor**, or pitch to a **Venture Capital fund**. This sucks, but it's a problem our budget has given startups.

For Angels and Seed Investors

If you're an angel investor, you could consider creating **an off-shore entity** that can invest in startups. There are other issues with owning offshore entities as a resident; the Budget requires mandatory filing and then, can reopen your books for 16 years for scrutiny (versus six for a resident). Plus, the investment could be subject to wealth tax and if you get a great exit, you will be charged capital gains tax at 30%, and so on. It's messy, but a good accountant might validate the offshore approach on a case-by-case basis.

A set of angels can set up a **venture capital fund** instead. Look here for the procedures and requirements. In essence:

- Create an investment vehicle (the "fund") which will launch "schemes" that raise money from investors.
- A minimum of Rs. 5 crores (50 million) needs to be committed before a VC fund is approved. This is already beyond the limit of most angel groups (who typically invest Rs. 10-50 lakh per company)
- SEBI charges fees of Rs. 600,000 .
- Oversight and regulations that let SEBI inspect books at any time, appoint other people to run the fund or demand more data.

Lastly: Angel investors could **just do it anyway.**

We could protest against this law forever, but if it's happening anyhow, we just have to work around it. Technology, life and startups can't wait for the aging bureaucracy to respond. At the small investment level: What if you invest anyway, as convertible debt?

Fear of the taxman is valid, and it might be that such an investment gets called into question later. They might tell you that convertible debt was "quasi-equity". They might then charge you a tax and penalty. But wouldn't the returns outweigh the risk?

a) Small investments might not be worth the taxman's time; so it is likely that such a situation only comes up when you are really big.
b) If you get really big, the tax you'll pay on that angel level investment is going to be **tiny**, and in all likelihood you can explain away your early "over-valuation" saying: see, we got to where we are today, the valuation then was justified.

But this is small consolation. People like things to be straightforward. It's not nice to have to look over your shoulder all the time. Our government doesn't make it easy.

Frequently Asked Questions

It's Only Active in 2013-14!

The clause applies to "Assessment Year" 2013-14. In that year, you file taxes for 2012-13. It's one of those strange budget things, but when they say assessment year they mean it applies to the year preceding it.

See the memorandum and search for Section 56, this clause is at the end:

This amendment will take effect from 1st April, 2013 and will, accordingly, apply in relation to the assessment year 2013-14 and subsequent assessment years.

The assessment year 2013-14 is for financial year starting April 1, 2012.

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The Clause applies to investment from a "Person". Angels can create a company and invest.

Under Section 2 of the IT Act ("Definitions") :

"**person**" includes—

(i)	an individual,
(ii)	a Hindu undivided family,
(iii)	a company,
(iv)	a firm,
(v)	an association of persons or a body of individuals, whether incorporated or not,
(vi)	a local authority, and
(vii)	every artificial juridical person, not falling within any of the preceding sub-clauses.

The last entry might even include an LLP (not listed specifically). But this definition means angels can't get around by creating a company

Startups Will Spend All That Money, So No Profit To Pay Tax On!

If a startup gets investment it will use most of it up in the year. Even if the tax department classifies the money as income, it will be offset with the expenses thus, no tax will apply.

There are two points to note here.

First, these "loss" that startups incur in the first few years are offset by profits in subsequent years (losses are **"carried forward"**). This is a tax element that is legitimate; so if you make a profit in subsequent years, you **don't** have to pay the government any tax until you've **covered up** your earlier losses. Effectively, by treating investment as income, the startup tax will eat into future profits.

(Loosely speaking, losses carried forward are an "asset") Either you will pay the tax today, or tomorrow; it's a tax all the same.

Second, note that **not all expenses are written off in the first year**. Yes, some are, like salaries. But if you buy assets – tables, chairs, a UPS, equipment, machinery and such – these are "depreciated" over time (a different time for each kind of asset).

In a simple scenario where you get Rs. 10 lakhs and use it to invest in equipment with a depreciation rate of 10% a year, the total 'expense' in the first year is Rs. 1 lakh. If the investment is treated as income, you have 10 lakhs of income with 1 lakh expense; so your "profit" is Rs. 9 lakhs, on which tax applies. (Remember, at this point you don't even have money as you used all that 10 lakhs to buy equipment!)

But This Will Curb Black Money?

If anyone is aware of the system of black money, it is the tax department. Black money is either money on which you don't pay tax, or money obtained through corruption. Or both. If an investor legitimately invests in a company, using a cheque from a bank account, is the "black" money the fact that his money is tainted? In which case, use the "**Section 68 amendment**" to explain the investor's sources instead; this fair-market-value clause is unnecessary. (Read: Private Cos: Investors Must Reveal Source Of Funds)

The other thing is that this clause does not apply if your investor is a **non-resident**. It is easy to route money abroad and then bring it back as "investment"; if that is all it takes, how can it prevent black money?

One of the key issues with the 2G scam was that Indian companies got licenses cheap and immediately, sold stake in their companies, at huge valuations to foreigners like Telenor (Norway) or Etisalat (UAE). Will the startup tax hit such an obvious flouting of valuation? Answer: No, because those new investors are non-residents.

The only-for-resident clause is a give-away; this was never meant to check black money or corruption, but really, in my opinion, a convenient way for the enterprising among the Income Tax officers to demand rent for (not) using the huge discretionary power they now have.

Can't Startups or Angels go Abroad?

Not every investor can, and it's expensive, through it seems the Singapore route may not be. However, do we really want to be telling our startups that we can't invest in them unless we go abroad? And what's to stop the tax department from easily including foreign investment in the clause?

Going abroad has other ramifications. Wealth held abroad is subject to wealth tax. From this budget, you have to report in more detail on your holdings abroad; if they find out you've created a company abroad to invest in Indian companies, will they just ignore it? The General Anti Avoidance Rules (GAAR) will likely be used to squeeze the life out of the investor.

A startup relocating abroad is more painful. You hire here, you work here, you know the market here. How do you service that market from abroad? If you sell locally, you need local presence. While some companies will be able to go abroad, create an entity, and then come back create an Indian subsidiary, this avenue is fraught with risk and expense.

I hate to think of "going abroad" as a solution. In the 90s, I refused because I wanted to start a company. In the 2010's I should go abroad if I want to start a company?

Public Response

There is an *iPetition* that you can sign to show your support for removing the startup tax. Also, visit the Facebook page ("No Startup Tax").

The Hindu interviews Raman Roy (Quattro) and Saurabh Srivastava (Indian Angel Network) about this clause. FirstPost finds a number of entrepreneurs and investors find the change distasteful.

The outrage has prompted a response: S. Ramadorai of TCS fame has been asked to advise the Government on this issue.

My response: We need to get rid of this clause. There are other ways, like GAAR or the Section 68 change, to trap investors that abuse the law. As a limited compromise, investments less than Rs. 5 cr. per year should be excused. (Early stage investors typically invest less than that) But in the long run, this clause serves no purpose and needs to go.

Conclusion

The Startup Tax is negative for all entrepreneurship in India. It's not just against the small tech startup, but nearly every private limited company, even the large ones that sell their shares at a premium. Sadly, we are revisiting the old days when even your IPO price was decided by a bureaucrat. The slow rolling back of liberalization with the introduction of the high-handed bureaucrat can rapidly derail the India story.

I've put a series of articles under the tag Startup Tax on capitalmind.in. I will revisit the issue as more clarity emerges.

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About The Author

Deepak Shenoy writes about Money, Markets and Trading at Capital Mind. He also runs MarketVision.in, an online financial education service. He has been an entrepreneur from 1998, having started three companies and helped run a fourth.

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