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Tax on allotment of shares by start-up firms

If the government is really keen that business should grow, it should encourage investment in companies, rather than deter such investments by uncertain tax laws

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Some of the recent controversial provisions in our tax laws pertain to taxation of transactions in shares of unlisted companies. In essence, there are three such provisions.

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First, if the shares are sold by a shareholder below the fair market value (FMV), he has to pay capital gains assuming the FMV to be his sale price. Second, the shareholder who acquires such shares below the FMV is required to pay tax as normal income on the difference between the FMV and the purchase price. Third, a company which allots shares at a price above FMV is required to pay tax on the difference between the allotment price and the FMV.

This has created an extremely difficult situation for most start-ups. If they allot shares below FMV, the shareholder may get taxed. If they allot shares above FMV, the company gets taxed. To add to the complications, the tax authorities have started challenging the FMV valuations, disputing the assumptions and projections underlying the valuations. Whatever one does, one is therefore likely to face disputes with the tax authorities.

This is an extremely hostile and uncertain environment for any unlisted company, in particular, a start-up, which is looking at raising funds at high valuations based on its business prospects. There are exemptions provided for investments by venture capital funds, and for investments in certain eligible start-ups. The definition of start-ups for this purpose is restrictive as well as subjective, being eligible only for the first 7 years, and only if it is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation. Further, its turnover should not exceed Rs25 crore. This makes only a few companies eligible for the exemption. Besides, given the subjectivity regarding the nature of business, tax officers have been taking aggressive stands that the business does not qualify for exemption, leading to litigation, and funds getting blocked in the process.

The rules for FMV do provide for some leeway, in that the valuation for allotment of shares by a company can be on the basis of the discounted cash flow (DCF) model, which takes into account future projections of cash flows of the business, resulting in a higher valuation based on the rosy future prospects of the company, unlike valuation rules for acquisition of shares by a shareholder, which is based on present book value. However, the aggressive stance of tax officials, challenging the very projections on which the valuation is based, has made this a highly litigious issue. Tax officers try to claim that the real future profitability and cash flows should be much lower, the FMV is therefore low and that the company is liable to pay tax on the difference between the issue price and the FMV.

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The government does not realise that valuation, particularly under the DCF method, is subjective exercise. As the saying goes—value lies in the eyes of the beholder. No two valuers would ever arrive at the same valuation, though both may be equally expert in valuation. To tax certain amounts as income on the sole basis of difference in valuation is

therefore really the taxing of a notional income, and not a real income. Further, tax officers, who have no understanding of commercial realities, are the worst possible persons to sit in judgement on whether future projections of a business are justified or not.

One understands that these provisions were introduced on account of shares being issued at high valuations by companies owned by politicians, which were really bribes disguised as investments. However, the exceptions should not make the norm and thousands of companies should not be made to suffer for the misdeeds of a few politicians. There are other laws under which such transactions could be held to be fraudulent, without burdening other taxpayers with litigation. The government needs to realise that business can only thrive where the business and tax climate is certain. Uncertainty and risk of litigation stifles the growth of business. If the government is really keen that business should grow, it should encourage investment in companies, rather than deter such investments by uncertain laws. Any shareholder would think twice before making an investment, which is likely to result in high cost and long drawn-out tax litigation.

Exempting only small start-ups or venture capital investments is not really a solution. As start-ups grow, they continue to need further investments to fuel their growth. Further, the very definition of start-up indicates that it has to be a scalable business model or have a high potential of wealth creation. However, the anomaly is that when the business succeeds in really scaling up or generating wealth by having a turnover exceeding Rs25 crore, the exemption is taken away. This is indeed a sure-shot disincentive for businesses from scaling up. One would have thought that success would be encouraged and rewarded, certainly not penalised.

One thought that the recent budget was an opportunity for the government to correct this. Unfortunately, it has preferred not to do so. One hopes that the government at least issues some instructions to tax officers, to check their overzealousness, putting certain checks and restrictions on their ability to challenge the assumptions and projections.

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