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Startup Investors propose seminal changes in tax and regulatory regime to enable Prime Minister's Startup Action Plan in high gear

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Industry advocates- Indian Angel Network (IAN), NASSCOM, TiE, Mumbai Angels and IVCA with Nishith Desai Associates have come together to propose tax changes for a more impactful Start up India Program, higher growth startups, increased job creation and increased contribution to the tax coffers.

The proposed changes could make a paradigm shift in India's entrepreneurial ecosystem.

Prime Minister Narendra Modi launched the Startup India programme in January last year as part of a campaign to create a conducive ecosystem for startups to boost job creation.

The press conference, held on Friday here, was addressed by Saurabh Srivastava, Co-founder and Past Chairman NASSCOM, Co-founder of IAN, Nishith Desai - Founder, Nishith Desai Associates, Harish Mehta, Co-founder and Past Chairman NASSCOM, Board member IAN, Rajat Tandon - President IVCA and Naveen Raju - Executive Director - TiE Mumbai.

Following are the highlights of the sections and actions proposed --

1. Sec. 56 (2) of the Income Tax Act ('ITA'): The government's Startup India Plan has unleashed innovation and entrepreneurship. The impetus provided could become more impactful if investments raised by startups were not taxed. Section 56 taxes capital receipt any amount above the fair market as assessed by the ITO. Startup ventures, at the stage where angels invest, usually have no revenues or profits and the valuation is based on the potential and promise of the idea, the background and competence of the founding team, etc. and is usually a matter of negotiation between the founders and the angel investors. Apart from converting disallowed capital investment to income, the tax levied further stresses the cashflow of the statup. This results in the company raising more money at a low valuation.

Startup companies are already facing this retrospective taxation and such notices damages to investor confidence and results in lower fund flows. It would also impact India's rankings on the Global Innovation Index, Global Competitiveness Index and Ease of Doing Business unless steps are taken to correct this immediately.

The investors proposed solution is in line with the Government's innovative idea of Startup Certification. They proposed that the Government recognise and approve angel investor groups and startups raising money from these groups be exempted from Section 56, unleashing faster growing startups, create jobs and contribute to the tax collections.

"We believe that the government has taken some very positive and innovative steps for the entrepreneurial ecosystem including the startup certification program. However, Section 56 is

retrograde and unfair and impedes the growth of innovative startups and job creation. Ring fencing startups raising money from recognised Angel Investor Groups, can make the Government's Startup India program alive," Saurabh Srivastava, Co founder & Past Chairman of NASSCOM, Co Founder of Indian Angel Network commented.

"A few initiatives will immediately create a viable pipeline of companies who can aspire to obtain registration as a startup and kickstart the FFS funded VCFs activities, these being tweaking of the startup definition, allow all follow-on investments in the VCU, by the fund, until the end of the life of the fund and leverage of SIDBI contribution to be capped. We urge the government to take these recommendations into consideration and together help build a more favourable startup ecosystem in our country," Rajat Tandon, President, Indian Venture Capital Association said.

Further, speaking on section 68, Rajat explained, "Any premium to fair value is generally added by AO as unexplained income in the hands of the company and is taxed as other income. In a start-up, BV is not the driver of value and hence a lot of them are facing this tax litigation where their investors have put in money at significant premium to book value."

2. MAT: Startup India program has given an income tax break to startups in three of the five years of its existence. The investor group proposed that it is only a small fraction of startups that would become profitable in the initial years. It would be more useful if the companies were exempted from paying MAT - tax on book profit. This was tax levied on unrealised profit and a startup is really paying from its stressed cash flows.

3. LTCG: Government's relaxation on Long-term Capital Gains from three years to two years on unlisted companies was widely lauded. However, considering that angel/early stage investors are taking a much higher risk when investing in startups compared to publicly listed companies, the investors proposed that LTCG for unlisted companies be at least aligned with that on listed companies at one year. This would still not be recognising the risk levels that angel/early stage investors take by investing in startups but it would bring parity. The taxation treatment for capital gains and the holding period should be the same for listed companies and unlisted companies where investments have been made by VC funds or recognised angel groups.

4. Section 115UB: The venture capital industry pointed out that tax was payable on the success of each company and the VC Fund was not allowed to carry forward this tax through the life of the Fund. This was unfair as while one company could give a return, the VC Fund could be a loss. Hence, the Investor in the VC Fund is unable to leverage the tax paid against one success against the overall loss that the Fund might make. The proposed solution was that tax paid by the Fund on the exit of one company be allowed for carry forward through the life of the Fund and be netted off against any loss.

5. ESOPs to Mentors: Deep engagement by mentors are critical for a startup and for a cash stressed startup, equity is the best way to compensate its mentor. Currently, non-employees and non-directors are not eligible for ESOPs. Investors proposed relevant changes be made to allow companies to issues ESOPs to mentors.

The early stage Investing industry spoke in a single voice proposing tax/regulatory changes which could put the startup ecosystem in high gear.

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