Government proposes tax exemptions on Esops, VC investments in startups

The ministry of communications and information technology has proposed tax exemptions on stock options given to employees by startups and on capital gains made from investing in new ventures, moves that could have a catalytic effect on such companies in the event the measures are adopted.

The proposals have been sent to the finance ministry as part of suggestions for next year's budget and are aimed at promoting the startup ecosystem, in line with the initiative that Prime Minister Narendra Modi announced in his Independence Day speech.

Some "70-80% of startups in the country are tech related and we need to find a way to encourage private capital and long-term investment in Indian tech startups," said an official.

The department of IT that's part of the ministry has also proposed that such exemptions on employee stock options (Esops) be extended to directors as well.

Startups are raising significant amounts of capital, especially at the early stage level, but they continue to struggle with opaque regulatory demands.

According to the current tax laws, angel investors in startups have to pay 33% short-term capital gains tax on all investments in Indian startups. Long-term capital gains tax, involving a holding period of three years, is 20%.

This contrasts with stock market investments, on which there is no long-term capital gains tax. Short-term gains are taxed at 15% within a holding period of one year.

India's rapidly growing angel investor community has been calling for parity for some time, asking regulators authorities to align the startup Esop policy with that of the stock markets.

The ministry has also suggested that individuals and corporate should not be taxed on capital gains if the money is invested in securities of startups.

Startups should also be free to wind up, the ministry has suggested. To this end, it has proposed "guidelines on valuations of startups and easy exits and no stigma for failure, like blacklisting etc. for financial institutions" unless it's for fraud, said the official cited above.

The Prime Minister has signaled through his Start up India, Stand up India programme that promotion of entrepreneurship and job creation will be a focus area for the government. ET had reported earlier that the PMO has held meetings to discuss ideas to make the environment more conducive for startups.

"We completely understand that we need to encourage investment and taxes need to go down if capital funding has to flow into the startup ecosystem if we want to recreate a Silicon Valley here," said the official cited above, adding that the government will move forward aggressively to foster innovation in technology.

A National Association of Software and Services Companies (Nasscom) report has ranked India among the top five largest startup communities in the world and that such companies have led to the creation of more than 80,000 jobs.

Both proposals are "fantastic," said Saurabh Srivastava, cofounder of the Indian Angel Network and Nasscom.

"It is a very, very positive step, and which could turn out to be transformational for the country's startup ecosystem," said Srivastava, also a member of the NR Narayana Murthy-chaired committee for alternative investment funds of the Securities and Exchange Board of India (Sebi). "We're not asking for extra benefits, all we want is to be aligned with the public markets."

Early stage investing activity in India will get a big boost if the proposals are accepted, experts said. Any changes to this effect would also act as an additional incentive for top talent to join startups.

"Any relaxation of constraints will definitely percolate handing out of Esops through the chain of the organisation, which currently isn't the case in India, as it is in... the US," said Srikanth Meenakshi, cofounder and chief executive of FundsIndia.com, an online mutual fund platform backed by Aditya Parekh's Faering Capital among others.

The adoption of the proposals could also allow startups to offer independent directors and highly sought board advisors stock, something that is not permitted now.

"When you have a good tax regime for Esops, you make a startup commercially viable," said Srivastava.

(Economic Times)