Promoting startup is a national priority. Recently, a newspaper report mentioned that a major steel company is contemplating an investment of Rs. 3000 crore in West Bengal that will generate an expected employment for 3000 people in the state- that translates to Rs.1 crore investments to create one job. A similar investment in startups and SMEs would definitely create at least five times more jobs. In order to offer enabling ecosystem to startups, three things are essential- providing reliable net connectivity in rural India, facilitating digital transactions and access to risk capital. The Union Budget of 2017 provides necessary incentives for enhancing net connectivity and encouraging digital payments. For example, section 44AD of the Income Tax is amended to lower the presumptive income for small and unorganized businesses (with annual turnover up to Rs. 2 crore) to six percent from the present eight percent only in respect of the amount of such turnover or gross receipts (out of Rs. 2 crore) received by account payee cheque/draft or net banking facilities. Thus, if a small trader receives 60% of her sales through bank and rest in cash; the presumptive income for tax purpose would be 6.8% of turnover.

The Union Budget (Budget) of 2016 announced a number of significant concessions/schemes for the startups. Five important announcements in Budget 2016 were: (a) 100% tax exemption in three consecutive financial years out of initial five years of incorporation of the startup; (b) abolition of angel investment tax; (c) setting up of ‘fund of funds’ for startups of up to Rs. 10,000 crore over a four year period; (d) lowering long-term capital gains for unlisted firms from three to two years so that sale of shares by unlisted firms beyond 2 years do not attract capital gain tax; and (e) allocation of Rs. 500 crore for SC/ST and women entrepreneurs. However, there was a catch. In order to avail above tax exemptions and benefits, a startup needs to satisfy conditions stipulated by the Department of Industrial Policy and Promotion (DIPP). Were the above incentives enough to significantly increase startup movement in India?

If one looks at a few countries and the government’s support for startups, one would note that India could do much more to promote entrepreneurial culture in the country. So, the expectation in Budget 2017, presented on 1 February 2017 in the Parliament, was much higher. Did Hon’ble Finance Minister meet the expectations? We would try to answer that question in this article. But before analyzing Budget 2017, let us look at government initiatives in two countries (other than USA) which are known for promoting startups.

**Government Support in Singapore**

Funding and other concessions initiated by various government agencies include five major areas- (i) equity funding scheme (*where the government co-invests with a private third-party investor in early stage of a business*); (ii) cash grants (*cash grant can vary between S$50,000 and S$ 300,000*); (iii) business incubation scheme (*to provide support to recognized incubators and also provide seed money to startups incubated by the recognized incubators- this is very similar to the schemes of the Technology Development Board (TDB)and*  *National Science and Technology Entrepreneurship Development Board (NSTEDB) of Government of India*); (iv) Debt-financing schemes (*availability of micro-credit of up to S$100,000 and SME credit of up to S$15 million at a concessional rate*); and (iv) tax incentive schemes (*full tax exemption up to S$100,000 taxable income, tax at 8.5% for next S$200,000 of taxable income in first three years and thereafter taxable income up to S$300,000 will be taxed at a concessional rate of 8.5%- which is 50% of the marginal corporate tax rate. Additionally, accelerated depreciation is available for expenditure incurred towards R&D, Intellectual Property Registration, IP acquisition, and design)*.

**Government Support in Israel**

Israel is home for new technology startups. An estimate[[1]](#footnote-1) shows that more than 1400 new technology startups were created in 2015 alone. The country spends more than 4% of GDP in civilian R&D. A startup, subject to conditions, is entitled to a preferred tax treatment (9% against the marginal rate of 16%). In addition, such an enterprise is entitled to investment grant, accelerated depreciation and reduced dividend distribution tax. Various incentive schemes have bias towards R&D focused enterprises. The national pre-seed grant (Tnufa programme) of up to $65,000 is available to individual inventors and nascent startup companies. Government-sponsored technology incubators programme provides funding up to $680,000 to each startup in addition to infrastructure facilities and mentorship support. Generous grant is also available for applied academic research in biotechnology and nanotechnology without any requirement of royalty payments to the government.

**Announcements for startups in Budget 2017**

Key highlights of this year’s budget so far as startups are concerned include:

*Increase in the tax exemption period:* The budget offers 100% direct tax exemption for three consecutive years out of initial seven years- thus a startup now gets two more years to avail the tax benefit. This provision will be effective from the assessment year 2018-19. The argument for such extension of time is that startups hardly make profits in initial years and hence if startups have to setoff the losses in first five years, very few would be able to enjoy the tax benefit. Is the two-year extension sufficient? What happens thereafter? If startups have to pay tax at marginal rate immediately after setoff benefits, it would cause great hardship, as profits would still be lower. It is better to offer a lower rate of income tax during the first decade of a startup. We have precedence in this respect- Indian IT companies enjoyed 100% tax holiday for many years and thereafter paid MAT(Minimum Alternate Tax) for a few years. The government is serious in pursuing its startup India policy and it would make immense sense if startups were provided a greater time window to pay tax at the full rate. It may be mentioned here that the reduction of corporate tax rate from 30% to 25% for MSME (Micro, small and Medium enterprise) sector is a praiseworthy step. Therefore, a more generous tax scheme for startups was expected. Two-year extension of exemption period is good but not enough.

*Amendment of Section 79 of the Income Tax Act:* In order to carry forward and set of losses as mentioned above, section 79 of the Income Tax Act had a restrictive clause- the promoters of the startups, which are privately held, should hold at least fifty-one percent of the voting right. This provision had created a major hurdle in raising significant funds in the initial years when a startup reports loss despite growth in topline. Promoters could not dilute their stake beyond forty-nine percent and many funders considered this restriction as a major hurdle in gaining controlling stake in startups. Budget 2017 makes necessary amendment in section 79 removing the restriction on the promoters to hold minimum fifty-one percent stake. Budget 2017 only requires that in order to avail the carry forward and set off benefits of losses in the initial seven years, the promoters of any startup should continue to hold shares without any minimum threshold.

*Capital Gains on Transfer of Shares*: The capital gain is generally computed by taking the difference between full value of the consideration received on transfer of a capital asset and cost of such capital asset. In case of listed companies, the value of the consideration is normally at or above the market price of the asset. However, it is found that in case of unlisted companies, the consideration received/offered could be lower than the fair value (estimated using recognized valuation methods) of assets (e.g., shares). A new section 50CA of the Income Tax Act would now provide that where consideration for transfer of share of an unlisted company is less than the fair market value (FMV) of such share, the FMV shall be deemed to be the full value of the consideration for the purpose of computing capital gains. This is a good move and will ensure that startups get fair value of their shares when they raise funds from Venture Capital (VC) or Private Equity (PE). Whenever any startup seeks to raise funds against shares, it needs a valuation certificate from a recognized valuer and the certificate should be a recent one. The funders (and the promoters of a startup) typically decide quantum of funding and equity stake on the basis of the enterprise valuation. However, funders would always prefer to provide the fund in tranches to ensure that the startup meets certain milestone and follows a desirable growth trajectory. The problem that a funder would face in such a situation is if the subsequent tranches are offered on the basis of original valuation, it may lead to purchase consideration being lower than the FMV at the time of disbursement of funds. If the startup has to get a fresh valuation every time it receives instalment of funds it would be an expensive proposition for the startup. The funder also has a problem- it would get proportionately lower stake for subsequent tranches on the basis of fresh (supposedly higher) valuation. In order to resolve the problem section 50CA could include a provision that any valuation certificate would be valid for one year so that there is no need of further valuation exercise for funds raised within that period of one year.

The above provisions would definitely benefit small and young enterprises. However, these are not enough to encourage scientists and academics.

1. <https://www.rolandberger.com/publications/publication_pdf/tab_start_ups_israel_final.pdf> (accessed on 2 February 2017) [↑](#footnote-ref-1)