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Budget FY16

Accelerating the start-up sector

Domestic VC-funding needs to be encouraged even as Start-up India Action Plan commitments are implemented

WITH an aim to accelerate the boom in the Indian start-up sector, the government unveiled the Start-up India Action Plan in January 2016. The plan sought to resolve the regulatory and financial challenges faced by the sector and several positive initiatives were announced as a part of this action plan. The start-up community is now in eager anticipation of the Budget FY17, to see how the government moves towards fulfillment of these plans.

One of the most important aspects to fuel start-up growth is to ensure ease of doing business. First, we need to remove the distractions of a web of compliances required to operate a business in India. The mobile app and online portal announced in the Start-up Action Plan, where start-ups can take off just by filling a short form, is a welcome step. This will enable them to focus on their core business by relieving them of the burden of the compliance mechanism.

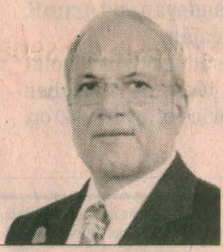
Second, aspects of self-certification compliance and 'no inspections' for the first three years will help reduce the regulatory liability on start-ups in early years. Besides this, simplifying patent and IPR procedures for start-ups is another positive move.

Swift and correct implementation of these provisions announced by the government is essential and the sector is looking forward to some actionable announcements in the upcoming budget for implementation within the coming financial year.

Another significant aspect for start-ups is financing. While the prime minister has announced several schemes—availability of debt by allocating ₹2,000 crore for Credit Guarantee scheme and a ₹10,000 crore fund to back start-ups, more needs to be done.

Only about 15-20% investment from Fund of Funds would be used for investments while the remaining 80-85% will need to be raised. Today, as high as 90% of the venture capital (VC) funding is raised overseas and can easily dry up owing to weak investor sentiment. Therefore, a domestic source of VC needs to be opened up. Enabling measures for pension funds, insurance companies, banks, etc, are required, to help them invest a part of their corpus in Sebi-registered VC funds. Seed or early-stage investing involves high risk. Therefore, the need for domestic capital is greater as foreign investors will find it far more difficult to understand the potential of start-ups in the country.

A critical impediment is that investments by Sebi-registered (AIF Category I) and angel groups are treated unfavourably vis-a-vis investment in listed companies, with regard to capital gains tax.



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An alignment of the capital gains tax regime, both period and tax rates, with publicly-traded investments is required to increase the flow of both institutional and HNI capital into start-ups/ early-stage enterprises

AIFs and angel groups, through such investments, take a far higher risk—largely illiquid as they cannot be traded or pulled out easily—to create new jobs and economic growth as compared to the mere trading of listed companies' stocks. This is because:

The capital gains tax rate on investments in publicly-listed companies stands at 0% for long-term capital gains (if held for over one year), and at 15% for that held for less than a year (short-term capital gains). Investments in unlisted companies are treated as long-term if they are held over a period of three years and there is a capital gains tax of 20% on long-term capital gains and tax of 33% for short-term (investment held for less than three years) capital gains. An alignment of the capital gains tax regime, both period and tax rates, with publicly-traded investments is required to increase the flow of both institutional and high networth individual (HNI) capital into start-ups/early-stage enterprises.

If this is done for Sebi-registred VC funds and angel funds investing in start-ups, it will reduce the ongoing discrimination against domestic funds as VC funds from abroad pay no taxes in any case, using treaties with Mauritius and other nations.

It is imperative to bring in these tweaks as the ₹10,000 crore fund has the potential to raise another ₹80,000 crore of funds for early-stage or start-up funding.

The government has also announced an exemption from income tax for the first three years, for start-ups set up post-April 1, 2016. Although, start-ups mostly make no or minuscule profits in the initial years, it is still a positive move.

However, it is not clear whether these exemptions are applicable for three years from the time the start-up incorporates or from the time the start-up starts reporting profits. It is relatively redundant if the exemptions apply to the former but if it applies to the latter, then the government deserves much credit for the support. In any event, a company ceases to be a start-up after five years; therefore, if it starts making profits only from its sixth year, this exemption is most likely not applicable. The government's position on this certainly requires more clarity, and this is expected from the Budget.

The Start-up India Action Plan is mostly optimistic and shows a very positive sentiment held by the government for the sector. What will be crucial for Budget FY17 to have is the announcement of the details for the implementation of these plans.

The author is founder, HCL