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Start-ups will need more tax exemptions, incentives to flourish

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Prime Minister Modi launched an action plan to promote start-ups in India amidst much fanfare in January in New Delhi. Whilst the Prime Minister announced several important reforms, some changes that start-ups would like to see in the Union Budget are as follows:

Taxation of employee stock options

Considering the fact that most start-ups are in a position to pay limited salaries, ESOPs are used as a tool to attract and incentivise quality talent. Typically ESOPs are granted to employees which may be claimed by them over a period of time. At the end of such period, the employee is allowed to pay a minimal value and is issued shares. Currently, ESOPs are taxed at the time of exercise i.e. when an employee decides to pay and avail of his shares in addition to the capital gains tax that may be payable at the time of sale of those shares. Considering that the employees only receive cash for their shares at the time of exit, ESOPs should ideally be taxed only at the time of sale and not at the time of exercise.

Service Tax/VAT exemption

The action plan announced an exemption for start-ups from paying income tax for the first three years. However, in reality this exemption would benefit only a minor portion of start-ups since most start-ups do not end up earning any taxable income in their first three years.

However, given that selling products and services is the biggest challenge a start-up faces, service tax/VAT is a huge burden on the resources of start-ups early on in their lifecycle. Therefore, an exemption should be provided to start-ups from paying service tax/VAT that will make them more competitive and improve their chance of success.

Extension of the Sec. 56 exemption to angel investors

As per Section 56 of the Income Tax Act, 1961 in the event that a company receives consideration for issue of shares in excess of fair market value of such shares, such excess consideration will be taxed in the hands of the company as income. Therefore, if the company is issuing shares at Rs.150 and the fair market value of such shares is Rs.100, the difference of 50 rupees would be treated as income in the hands of the company and consequently taxable.

The action plan proposed exempting incubators from such tax. Whilst this is a welcome step, incubators in addition to investing also provide various other services. Individual investors on the other hand are able to provide risk capital across a wider spectrum of companies. Therefore, investments received from them by companies should also be exempt.

Taxation of share swaps

A share swap for a private company essentially results in the shareholder receiving illiquid shares and no cash in lieu of his shares. Given the fact the shareholder does not receive any cash or liquid shares such transactions are usually tax exempt in other jurisdictions under the pooling of interest accounting method. However, currentl such share swaps are taxed i the same manner as transfe of shares. Thus, the sam principles that are applicab for a tax-free merger shou also apply to share swaps.

While start-ups may have huge wish list of deman from the Finance Minister, v believe that these few ste will go a long way in galvan ing the entire start-up e system.

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