Budget 2020 for startups – Band-aid instead of tourniquet?

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Sanjay Nagra

Kamlesh Rao

The union budget for 2020 was expected to deliver a much-needed boost to an economy in a slump. A key component of this economy in recent years has been the country's thriving startup community that has not only been delivering consistent and far-reaching innovation that is changing the face of commerce in India but also been attracting substantial amounts of foreign exchange into the country as FDI.

While the government had, over the course of last few years, brought in a number of changes to make it easier for startups to do business and stay in India, the budget announced today failed to carry forward that momentum and deliver on the high expectations that were set for growth in this sector.

Arguably, the biggest direct takeaway for startups from this budget was the deferment of the payment of income taxes payable upon exercise of stock options (ESOPs) by their employees. ESOPs are extremely critical of employee compensation for startups and the erstwhile obligations on employees to pay taxes at the time of exercise of their ESOPs (which in most cases, was before they had liquidity with respect to the underlying shares) reduced the attractiveness of ESOPs for many employees.

The proposed change in policy now allows the required prerequisite tax to be deducted at the earliest of (a) the employee leaving the company; (b) the sale of the resultant shares by the employee; and (c) the fourth year from the end of the relevant assessment year. However, the scope of companies that would benefit from this has perhaps been left too narrow – the benefit has been made available only to employees of inter-ministerial board-certified startups alone (and not all DPIIT-registered startups), which currently make up a very small fraction of startups in the country.

The turnover limit for startups to be eligible for a deduction of three-years' profits has been increased from Rs 25 crore to Rs 100 crore and the period of eligibility to claim this deduction has been increased from 7 to 10 years. It must be noted, however, that similar relaxations of turnover and eligibility periods for other regulatory concessions were already carried out earlier, and that this is merely a case of tax laws "catching up".

Further, startups in specific sectors are likely to benefit from the initiatives announced by the government for those sectors – for instance, the announcement of an app-based invoice financing product and setting up of private sector data centres are expected to give rise to the next wave of FinTech startups while startups in the B2B logistics space should benefit from the push-in logistics, infrastructure, and warehousing sectors. The announcement of a seed fund to support certain early-stage startups will add a much-needed source of early-stage funding in a highly competitive fundraising ecosystem.

Startups will also incidentally benefit from the increase in equity investments, particularly FDI, that will now likely result from the removal of the requirement to pay dividend distribution tax and other proposed policy changes.

Much needed reliefs that startups would have greatly benefited from, such as extension of ESOP tax rationalisation to all DPIIT-registered startups, ease of transfer pricing compliances, steps to increase rupee capital in the market, and a further reduction in corporate compliances, have, however, been left out of the budget, which has made this budget, overall not the shot in the arm that the sector was hoping for.

Sanjay Khan Nagra is a Partner and Kamlesh Rao is a Senior Associate at Khaitan & Co. Tags budget 2020 india DPIIT ESOPs FDI india budget Nirmala Sitharaman Startups tax budget 2020 union budget Union Budget 2020