Standing Committee Report Summary

Financing the Startup Ecosystem

- The Standing Committee on Finance (Chair: Mr. Jayant Sinha) submitted its report on 'Financing the Startup Ecosystem' on September 9, 2020. A startup ecosystem consists of startup accelerators, venture capitalists, private investors, entrepreneurs, government, corporations, mentors and the media. The Committee recommended changes in taxation and other regulation to broaden avenues for investment in startups and improve domestic investor participation. Key observations and recommendations include:
- **Scaling up unicorns**: Unicorns are startups that are valued at over one billion dollars. The Committee noted that capital raised by unicorns mainly comes from foreign sources such as US and China. To encourage domestic capital, the Committee recommended expanding the Small Industries Development Bank of India (SIDBI) Fund-of-Funds to help disburse more funds to startups. SIDBI Fund-of-Funds is a fund that invests in other funds such as alternative investment funds (AIFs). AIFs pool private funds for investment in startups and other companies.
- **Abolition of long-term capital gains tax**: The Committee recommended that tax on long-term capital gains should be abolished for two years on investments in startups made through collective investment vehicles (CIVs). After the two-year period, the Securities Transaction Tax (STT) may be applied to CIVs (instead of long-term capital gains tax) to ensure revenue neutrality for the government. STT is a tax imposed on purchase and sale of securities and is currently applicable for listed securities. CIVs are entities (such as angel funds and AIFs) that allow individuals to pool their funds for investment.
- **Asset management services not be subject to GST**: Foreign investment in startups can be made through AIFs incorporated in India or non-AIFs which are domiciled outside India. Both AIFs and non-AIFs employ fund managers that provide asset management services. Management services provided to non-AIFs is considered as export and non-AIFs are not charged GST. Whereas AIFs are liable to pay GST. The Committee noted that this creates an incentive for investors to offshore funds resulting in poor growth of asset management industry in India. It was recommended that to ensure parity, management services to foreign investors, whether pooled onshore (AIFs) or offshore (non-AIFs) should be considered as export so they can claim GST exemption.
- **Mobilisation of domestic institutional funds**: The Committee observed that large pools of domestic capital available with pension funds, provident funds, banks and insurance companies are not being channelised as investment into alternate asset classes (such as AIFs, private equity, venture capital funds). The Committee recommended that (i) pension funds should be allowed to invest in unlisted AIFs and the requirement of minimum AIF corpus size of Rs 100 crore be removed, (ii) major banks should be allowed to float fund-of-funds and be allowed to invest in Category-III AIFs (AIFs that employ complex trading strategies such as hedge funds) and (iii) insurance companies should be allowed to invest in fund-of-funds floated by Insurance Regulatory and Development Authority and directly in VC/PE funds and a higher exposure limit should be permitted for the same. Insurance companies are allowed to invest between 3% to 5% of their investment funds in AIFs.
- **Listing of AIFs**: In order to enable AIFs to access a permanent source of capital, it was recommended that they should be allowed to list on capital markets.
- **Expansion of sectors for FVCI**: The Committee recommended that foreign venture capital investors (FVCI) be allowed to invest in all the sectors where foreign direct investment (FDI) is allowed. Currently, FVCIs are allowed to hold equity in unlisted Indian companies engaged in a limited number of sectors such as biotechnology, IT related to hardware and software and infrastructure sector, among others.
- **Expanding financing sources for startups**: The Committee noted that companies may be classified as non-banking finance companies (NBFCs) if more than 50% of their assets or revenues are derived from startups. It was recommended that companies should be allowed to invest in startups without being classified as NBFCs.
- **Incentive for long-term capital**: The Finance Act, 2020, excludes from calculation of total income, income from investment in the infrastructure sector, made before March 31, 2024, held for at least three years. It was recommended that this exclusion be allowed for long-term capital in all sectors.
- **Rationalisation of pricing guidelines**: The Committee noted that there are challenges in compliance requirements on investment by AIFs. There are regulations that govern the price at which shares can be issued (pricing guidelines). These guidelines are prescribed under various laws and regulations by Securities and Exchange Board of India (SEBI), Income Tax Act, Companies Act and Foreign Exchange Management Act (FEMA). The Committee recommended that these guidelines should be made more consistent to provide a simple framework. An expert committee may be set up to provide pricing guidelines to government authorities.

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