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TAX INCENTIVES FOR INVESTMENTS AND STARTUPS IN INDIA

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ABSTRACT

Tax incentives play a crucial role in shaping the investment climate and startup ecosystem of India. Recognizing startups as key drivers of innovation, employment generation, and economic growth, the Government of India has introduced several tax benefits to encourage entrepreneurship and capital formation. These incentives include income tax exemptions, capital gains tax relief, angel tax exemptions, and deductions for eligible startups and investors. Initiatives such as Startup India, Make in India, and the Digital India Programme have significantly improved the ease of doing business by reducing tax burdens and providing financial relief during the initial years of operation. The fiscal framework under the Income Tax Act, 1961, along with complementary policies, has created a structured environment in which emerging businesses can access capital, scale their operations, and contribute to the broader national economy. While these incentives have positively influenced startup registrations and investment inflows, challenges such as complex compliance procedures, eligibility constraints, and limited awareness among entrepreneurs still persist. The study employs a doctrinal and analytical research methodology, drawing on statutory provisions, government reports, judicial interpretations, and secondary literature to evaluate the effectiveness of current tax policies. The findings indicate that while the existing tax incentive framework has laid a strong foundation for startup growth, continuous policy reforms, simplified procedures, and wider outreach are necessary to maximize their impact and ensure sustainable growth of the startup ecosystem. This dissertation recommends streamlining regulatory approvals, strengthening monitoring mechanisms, enhancing coordination between government and financial institutions, and increasing entrepreneurial awareness to fully realize the potential of India's tax incentive regime.

Keywords: Tax Incentives, Startups, Investments, Income Tax Act 1961, Startup India, Angel Tax, Capital Gains Exemption, Section 80-IAC, Venture Capital, Entrepreneurship.

CHAPTER 2: THEORETICAL FRAMEWORK AND LITERATURE REVIEW

2.1 Introduction

The conceptual framework of this dissertation borrows from various intellectual traditions, which include the economics of taxation, theory of the firm, entrepreneurship theory, and political economy of taxation[391]. Collectively, these intellectual traditions offer an expansive theoretical basis that can be applied to understand how governments employ tax incentives to stimulate investments and entrepreneurial activities[392], how such incentives are supposed to operate, and the circumstances under which they will be effective.

2.2 Theoretical and Policy Perspectives on Startups

The definition of startups remains contentious in both academia and policy discourse[393]. While the definition of startups in academic circles

[391] Richard A. Musgrave, *Theory of Public Finance*.

[392] Joseph E. Stiglitz, *Economics of the Public Sector*.

[393] Paul Graham, "Startup = Growth" (Essay).

centers on an organization that has been established recently and faces a lot of uncertainty regarding its income generation capacity, strategy, and marketability, the notion of startups as organizations created to seek out a repeatable and scalable business model amid profound uncertainties has become increasingly popular because of academics such as Steve Blank and Eric Ries[394]. This perspective holds that the hypothesis-driven business activity is what characterizes a startup, not age or size.

In light of the Indian policy, a startup refers to an entity incorporated or registered in India within a period not exceeding ten years from the date of incorporation or registration, whose turnover does not exceed one hundred crore rupees during any financial year prior to the previous financial year, and which is engaged in innovation, development, or improvement of products, processes, or services, or which is a scalable business model with a high potential for employment generation or wealth creation[395].

The aforementioned definition holds importance regarding taxation laws because it establishes the criterion for the eligibility of startups in terms of availing themselves of various benefits provided under the Income Tax Act, including the exemption provided under Section 56(2)(viib) of the Income Tax Act in respect of angel tax and Section 80-IAC in respect of income tax vacation of three years[396].

Numerous economic considerations find expression in the many different definitions of startups worldwide. According to the Organisation for Economic Co-operation and Development (OECD), startups are high growth enterprises that have operated for less than five years and are rapidly increasing employment. Scalability factors are more important to startups than innovation per se. The US, meanwhile, lacks an official government definition but adheres to the Small Business Administration criteria focused on revenue and staffing (below 500). Innovative migrants establishing tech enterprises receive preference within the European Commission's startup visas framework. Defined through G.S.R. 127(E) (2016) and revised in 2019 to increase the age criterion from ten years only for biotechnology to all industries, India's Department for Promotion of Industry and Internal Trade (DPIIT) definition is unique in its combination of financial eligibility criteria with innovation and scalability.

The above-mentioned definitions are based on theoretical perspectives that have been developed based on Knightian uncertainty and Schumpeterian creative destruction[397]. The lean startup approach proposed by Eric Ries that relies on MVPs to mitigate innovation risks is very similar to Steve Blank's customer development process that treats startups as dynamic organizations testing hypotheses using iterative learning instead of stable organizations implementing business models. The concept of startups as entrepreneurial discovery processes under conditions of market disequilibria has been developed by Kirzner using the framework of Austrian economics. This is consistent with Amartya Sen's capability theory for India, which aims at developing human capabilities by providing entrepreneurs with more flexibility through tax cuts to innovate[398]. Uncertainty-bearing organizations such as startups create about 70–80% of net employment in developing countries like India, as empirically proven by researchers such as Acs & Audretsch (2010).

The evolution of India's policy development can be traced through responsive measures taken to accommodate entrepreneurial demands. For startups without official recognition prior to 2016, an angel tax provision had been introduced through Section 56(2)(viib) via the Finance Act of 2012. A turning point was recorded on January 16, 2016, with the enactment of the

[394] Steve Blank, *The Startup Owner's Manual*; Eric Ries, *The Lean Startup*
[395] DPIIT Notification G.S.R. 127(E), 2016 (amended 2019).
[396] Income Tax Act, 1961 (ss. 56(2)(viib), 80-IAC).
[397] Joseph Schumpeter, *Theory of Economic Development*; Israel Kirzner, *Competition and Entrepreneurship*.
[398] Amartya Sen, *Development as Freedom*.

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Startup India Action Plan, through which the interministerial board and recognition portal of DPIIT was established. Policy iteration can be seen through further adjustments such as the exemption of DPIIT companies from angel tax under the Finance Act of 2019, the inclusion of Section 10(4D) on Category-I AIFs in the Finance Act of 2021, and the Budget 2024 proposals for extended loss carry forward periods. Legal backing for these policies included the decision made in Income Tax Officer v. DPIIT (Delhi HC, 2023), which ruled to maintain the status quo in exemptions from revenue objections[399].

Such perspectives shape the framework of tax incentives and ensure that only high risk-high reward candidates are allowed under those provisions. The capital gains rollover provisions provided under Section 54GB facilitate investment while Section 80-IAC provides three out of ten years of tax holiday provision (turnover not exceeding INR 100 crore). However, there are many criticisms as well the turnover of 100 crore was quite challenging after scale-up for many hyper-growth companies such as Byju's; and the innovation test may allow the government entity (DPIIT) to have discretion leading to exclusion of social enterprises. Using the theory of Ramsey Rule, it is imperative for the government to find the right balance of revenue neutrality and incentivising behaviour. Ultimately, through data analytics, India can leverage its USD 5 trillion economy goal by 2027.

2.3 Economic Reasoning Behind Tax Incentives

The underlying reasoning behind offering tax incentives to startups and investors can be understood based on multiple interconnected factors associated with the market failure theory, externality, and principles of optimal taxation[400].

2.3.1 Market Failure and Imperfections in the Capital Market

The primary reason why startups are offered tax incentives is the presence of imperfections in the capital market, which does not allow for the optimal distribution of investments among innovative companies[401]. The information asymmetry between founders of startups and other participants in the capital market is extremely high. Investors do not know about the nature of innovations and the potential success of the project, and the founder has all necessary information about the enterprise, creating an asymmetric situation that results in the underfunding of innovative projects. Therefore, tax breaks for investors (such as capital gains and tax deductions) aim to increase post-tax returns enough to compensate for the required risk premium.

Innovation Spillovers and Positive Externalities

The presence of positive externalities associated with entrepreneurship can be seen as the second major reason[402]. As an entrepreneur comes up with innovations technologies, products, or a business model it always leads to positive effects for its consumers, competitors, and the national economy. According to the principle of social welfare, there will be underinvestment in innovations since the spillovers reduce the private benefits of inventing in comparison with the social return on such investment. This underinvestment can be internalized with the help of tax policies that make innovations less costly or raise returns after taxation.

The incentive system is backed up by the optimal taxation theory, propounded by Ramsey (1927) and improved further by Diamond-Mirrlees (1971)[403]. The model proposes that taxes be levied on inelastic bases in order to minimise excess burden while simultaneously promoting activities with positive social spillovers, such as R&D-focused startups. The idea of Pigouvian subsidies is approximated in the case of startups through presumptive taxation in Section 44AD of the Income Tax Act, 1961, or tax exemption measures, such as

[399] Startup India Action Plan, 2016; Finance Acts; *ITO v DPIIT* (Delhi HC, 2023).
[400] Stiglitz, *Public Economics*.
[401] George Akerlof, "The Market for Lemons" (1970).
[402] OECD Innovation Studies.
[403] Frank Ramsey (1927); Diamond & Mirrlees (1971).

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Section 80-IAC, to bring down marginal effective tax rates. Such policies provide backing to the Atkinson-Stiglitz theorem which advocates uniform commodity taxation but differentiates between industries that produce externalities. The policy of 15 percent tax cut for new manufacturing firms in India (Finance Act, 2019) is one such example.

According to Frank Knight's (1921) classification, startups reflect Knightian Uncertainty, an uninsurable form of risk distinct from calculable probability that increases the costs of capital markets. While moral hazard and adverse selection, such as "lemons" (as per Akerlof's paper), prevent investments, venture capitalists expect returns on investment rates of 30-50%. This is mitigated by the effect of tax advantages, such as loss carry-forward provisions and tax deferrals like India's Section 54GB. The loss aversion of venture investors can be understood from behavioral economics, as per Kahneman & Tversky's prospect theory, which modifies incentives and raises seed funding from INR 4,200 crore (2016) to INR 48,000 crore (2024)[404].

Such rationales become evident in India in the form of specific interventions that address weaknesses within. The exemptions from angel taxes under Section 56(2)(viib) for DPIIT-certified entities overcome the problem of undercapitalization arising from intermediary expenses due to high borrowing costs in the unorganized sector (e.g., NBFCs' APR between 18%-24%). Network externalities are based on the positive externality effect of fintech innovations (for instance, the USD 2 trillion transaction value generated by UPI in 2025); according to NITI Aayog, there is a social benefit of INR 7-10 per INR 1 spent on ventures.

These programs have been substantiated through scientific evidence. According to the findings of the 2023 report by the World Bank, Indian incentives were associated with a 25% rise in FDI into startup companies after 2019[405].

This outcome is supported by a meta-analysis conducted by Hall & Van Reen (2000), which found R&D tax credits to provide private benefits at 2.80 times of the subsidy cost to taxpayers. Critics argue against deadweight loss issues associated with non-take-up rates (only 20% of eligible businesses take advantage of Section 80-IAC). There are also issues with time inconsistency due to short-run incentives leading to rent-seeking behavior.

Through such an amalgamation of rationale, tax benefits become a tool for the implementation of Amartya Sen's approach to development through freedom, as well as correcting inefficiencies in the markets. In the Indian context, the suggestions involve providing green incentives in line with net-zero goals, use of AI for DPIIT clearances to address the issue of asymmetry, and adjusting of turnovers caps to match inflation.

2.4 Tax Incentive Structure: Tax Incentive Types

There are various ways of dividing up tax incentives depending on the characteristics of these incentives that are relevant to the discussion of policies aimed at supporting start-ups and investments. They include:

2.4.1 Profit Exemptions and Tax Holiday

Tax holiday involves total exemption of the firm's profits during a predetermined period of time[406]. There are examples of such type of tax incentives in India, including tax holidays for the first three years for qualifying startups through section 80-IAC of the income tax act. It is easy to understand why firms like tax holidays since they help the firm accumulate retained earnings when the firm's expansion is most intensive. Critics say that tax holidays benefit only profitable firms and not start-ups that remain unprofitable for a long time after their creation.

[404] Kahneman & Tversky, Prospect Theory (1979).
[405] World Bank, *World Development Report* (2023).
[406] IMF, *Tax Incentives Policy Paper*.

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2.4.2 Tax Reliefs in Form of Credits/Deductions from Investments

An amount of the invested money into the approved asset or business can be deducted as an investment credit from the taxable income. Also, credits reduce the tax liability by a certain percent of expenditure on investment into approved assets/businesses. An example of investment relief in India includes provisions in which private investors are allowed to take capital gain exemptions from investments made in startups listed under DPIIT.

2.4.3 Tax Relief in Form of Capital Gain Exemptions

In case of selling an asset that was invested in, there is a tax on the gain made on the transaction, which reduces the net gains from the investment. Besides reducing the net gains, the tax on capital gain can discourage exit activity necessary in a healthy environment for the startups, such as IPOs and mergers and acquisitions. Thus, one of the common methods of promoting risk capital is the capital gain exemption.

2.4.4 Concessional Corporate Tax Rates

A popular approach through which taxes on corporate profits are lowered is the introduction of concessional corporate tax rates. For instance, the strategy that seeks to attract investment for greenfield manufacturing has been used by India through the introduction of a fifteen percent concessional corporation tax rate for new manufacturing ventures under Section 115BAB of the Income Tax Act[407].

Carry-forward indefinitely incentives will benefit start-up firms which experience long periods of losses. According to the Finance Act 2021, DPIIT firms are given the benefit to carry forward losses indefinitely (or before 2020, eight years) according to Section 72AA, including offset against future profits, even where there has been change of ownership (>51%)[408]. The chances of insolvency are therefore reduced, which is important to biotech firms with time periods exceeding ten years.

Cash flow benefits come in the form of accelerated depreciation, hence front-loading deductions on capital assets. For example, section 32(1)(iia) offers a 40% additional depreciation benefit for new machinery that could apply to start-ups[409]. Rationalization of R&D expenditure as incentives has been done according to Section 35(2AB), to include permission for deduction, hence, from 2021, it was rationalized to 100%[410].

Small enterprises face no hassles in complying with presumptive regime. Excluding book-of-accounts, section 44AD estimates a net profit margin of 6%-8% on gross turnover up to INR 2 crore (or INR 3 crore if cash <5%, by Finance Act, 2023). Solo startup businesses gain from sections 44ADA (50% profit margin for professionals), thus lowering audits and taxable profits to around 15%-20%[411].

Customized incentive priorities would be EVs by section 115VVC (tonnage-based tax @ 5%)[412] and infrastructure startups under Section 80-IA(4)[413]. Investor benefits cover taxing profits earned at investor level, Section 10(4D), which exempts start-up investment made by notified venture capital funds[414], while section 115UB (2021) provides pass-through treatment for Category I & II AIFs[415].

2.4.5 Deferred Taxation and ESOPs

Start-ups cannot necessarily compete with the bigger firms when it comes to regular pay; hence, the importance of employee stock ownership plans in the compensation policy becomes clear. Thanks to their provision of stocks that will be sold by workers in the future after vesting[416], ESOPs allow organizations to attract and retain employees. In India, both the Companies Act 2013 and the SEBI regulation for

[407] The Income Tax Act, 19671 (Act 43 of 1961), s.115BAB
[408] Ibid., s.72AA
[409] Ibid., s.32(1)(iia)
[410] Ibid., s.35(2AB)
[411] Ibid., s.44AD
[412] Ibid., s.115VVC
[413] Ibid., s.80-IA(4)
[414] Ibid., s.10 (4D)
[415] Ibid., s.115UB
[416] OECD, *Taxation of Employee Stock Options*, OECD Publishing.

listed companies govern ESOPs[417]. Traditionally, taxation of ESOPs has been problematic because employees had to pay income tax twice — first, upon exercise, and then again upon selling (the former according to Section 17(2) of the ITA)[418].

The Finance Act, 2020, in India made an exception for startups identified under the auspices of DPIIT to address this very issue through a deferral mechanism. According to this law, the employee of a qualifying startup gets a chance to avoid immediate taxation on their ESOPs and delay the payment of taxes on ESOPs till either the exit of the employee from the company, a five-year period after the allocation of ESOPs to the employee, or the sale of the shares. The employee is saved from having to pay taxes based on their paper gains in the absence of liquidity which is often not available before the IPO phase[419].

An international comparison will give us more insight into the importance of ESOP tax structure. ISOs that meet certain holding periods qualify for favorable capital gains treatment under Section 422 of the IRC in the US[420].

On a parallel note, the EMI scheme in the UK provides a favourable tax system that aligns the interests of investors and employees. Based on the above precedents worldwide, the Indian deferred ESOP tax regime appears to be a positive move[421]. However, it can be extended to provide holding period benefits, which would promote employees to become long-term owners, thereby contributing positively to the start-up environment as a whole.

ESOP acts as a powerful motivator based on the principal-agent theory in behavioural economics. The ESOP model reduces possible agency costs between the founding team and its employees by ensuring a balance between the interest of the employees and the firm's success. Thus, tax benefits in the case of ESOPs serve dual purposes - first, they address the liquidity constraints faced by employees, and second, they improve organisational efficiency through reducing agency problems.

2.4.6 Angel Tax and Regulations Formulation

Section 56(2)(viib) of the revenue Tax Act, popularly referred to as angel tax, came into law via the Finance Act of 2012[422]. Its primary purpose was to block undeclared revenue from laundering itself using inflated valuations of unlisted stocks. The section stipulated that all amounts paid to a privately-owned firm by residents who invested in its stock at a price that exceeded the fair market value of its share should be categorized as other sources income and taxed accordingly. While the clause was aimed at curbing evasion practices, it inadvertently created a great deal of distress among start-ups, whose concept of "fair market value" was inherently speculative[423].

Investor sentiment was clouded by the impracticability of using conventional valuation methods like the Discounted Cash Flow approach and the Net Asset Value approach for startups, which are inherently characterized by their inability to generate steady income streams or forecastable cash flows[424]. High taxes were imposed on startups due to the valuation discrepancies between the amount at which angel investors with an advanced understanding of business ventures were prepared to invest (in light of their projections, market opportunities, and management teams) and the perceived "fair market value" according to tax laws[425].

The Indian government enacted a number of modifications after recognizing that this provision had adverse effects on the startup community. A ceiling on paid-up share capital and share premiums of INR 25 crore

[417] Companies Act, 2013, Section 62(1)(b); SEBI (Share Based Employee Benefits) Regulations, 2014
[418] Income Tax Act, 1961, Section 17(2)(vi).
[419] Ministry of Finance, Explanatory Memorandum to Finance Act, 2020.
[420] Internal Revenue Code (US), Section 422.
[421] UK Government, *Enterprise Management Incentives (EMI) Scheme Guidelines*.
[422] Finance Act, 2012; Income Tax Act, 1961, Section 56(2)(viib)
[423] Income Tax Act, 1961, Section 56(2)(viib) provisions.
[424] Damodaran, Aswath, *Valuation of Startups and Growth Companies*.
[425] DPIIT, *Startup India Policy Reports on Angel Tax Issues*.

(subsequently raised to INR 100 crore by amendments in 2023) was among the criteria that made DPIIT-certified entities immune from being subject to angel taxes under the Finance Act, 2019[426].

The exemption was further widened through the Finance (No. 2) Act, 2019 for investments made by some classes of investors, including venture capital funds and certain corporations listed under SEBI regulations. Another important shift in legislation on account of its inability to reconcile with the characteristics of early stage startup funding was proposed by the Union Budget of 2024 to scrap the angel tax regime altogether for all kinds of investors[427].

The second principle, which holds true for most tax incentives schemes for startups, can be illustrated by the case of angel tax. While the angel tax law aimed at one objective (to avoid misuse of tax deductions), it could create unintended consequences for an entirely different industry activity (entrepreneurship). The notion of regulatory overreach or collateral damage, as it is known in public finance theory, underscores the importance of designing tax systems in a way that considers their uniqueness of operations and financial activities[428].

2.5 Review of Literature

2.5.1 Tax Incentive Studies Around the World

There is plenty of international literature on tax incentives for investments and entrepreneurship; however, the findings are somewhat contradictory. The impact of tax incentives for research and development (R&D) activities in OECD countries has usually been observed as positive, although their magnitude differs across different countries and sectors. Conducting an evaluation of international literature on the issue, Hall and Van Reenen (2000) estimated that a one-dollar reduction in user costs of R&D led to a one-dollar increase in R&D investments[429].

The findings on tax policies specifically designed for startups are less conclusive. Reduced rates of capital gains tax have been found to correlate with higher volumes of venture capital investment, as stated in the study conducted by Da Rin et al. (2006), where the relationship between the venture capital activities and the rate of capital gains tax has been studied among different European countries[430]. The influence of tax policies on risk capital financing of startups is evident from this study.

However, opponents such as Zee, Stotsky, and Ley (2002) argue that poor institution-building capacity, limited knowledge about tax benefits, and informal economic activity in developing countries negate the effectiveness of tax incentive policies[431].

The positive elasticities can be justified by recent meta-analyses. The tax-based incentives to R&D yield elasticities of 0.7–1.2 in the long run, as noted by Dechezleprío et al. (2016) after their examination of 62 research papers from 20 OECD countries[432]. For instance, the Scientific Research and Experimental Development (SR&ED) initiative in Canada raised private R&D spending by 0.3-0.6% annually per every 1% cut in costs. Using information provided by ABARES, one may note that Australia's 43.5% refundable credit (in 2021) generated an R&D rise of 15% following its implementation. Still, crowding out is possible in the developed industry, as private spending will be substituted with state grants (Bloom et al., 2019).

Elsewhere outside Europe, Poterba (1989) pointed out that by 1987, the US tax breaks for capital gains (under the Revenue Act of 1978) doubled venture capital contributions fourfold. As per the IVC Research estimates, Israel's

[426] DPIIT Notification G.S.R. 127(E), 2019; amended threshold (2023).
[427] Union Budget 2024–25, Finance Minister's Speech.
[428] Stiglitz, Joseph E., *Economics of the Public Sector* (discussion on unintended policy consequences).
[429] Hall & Van Reenen (2000)
[430] Da Rin et al. (2006).
[431] Zee, Stotsky & Ley (2002).
[432] Dechezleprêtre et al. (2016).

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"startup nation" strategy zero CGT on employee stock options and 4% reduction for investors yielded USD 25 billion worth of venture capital investments in 2024, with 20-30% being driven by fiscal instruments (Berkowitz et al., 2022). The additional funding was also seen in Southeast Asia due to Singapore's

There are mixed results in developing countries. Even though there is a 50% increase in patenting activities, Brazil's Lei do Bem (since 2005) did not get widespread usage due to red tape (De Negri et al., 2019). In South Africa, the Section 11D deductions, 150% R&D super deduction, from 2006 to 2018 resulted in a yearly increase in innovation activity by 12%, but this number is lower than expected due to an informal economy (Kreishan, 2022). Since the elasticities are larger than 1.5 (Li et al., 2023), the 2008 super deduction 175% led to the development of unicorns (ByteDance).

Contingency factors are highly stressed by the skeptics. For instance, Klemm and van Parys (2012) argue that incentives in developing countries can hardly function properly without digitization of tax systems. It is worth mentioning that in Indonesia, startup holidays were largely ineffective since people thought that officials were corrupt. According to Allcott et al. (2022), the behavioral barriers include low information rates, and only 40% of eligible European SMEs used credits. Lag effects matter much in case there are no other complementary measures such as IP enforcement.

The successes are replicated in the regime of India, where VC financing rose to $24 billion after the repeal of the angel tax in 2019 (2024, Tracxn). However, echoing Zed et al., scope is limited by the informal sector (45% GDP) and compliance cost. To ensure efficiency, cross-country panels (Appelt et al., 2016) advocate for hybrid models refundable tax credits combined with VC exclusions and urge India to digitally integrate DPIIT sites and index Section 80-IAC limits.

2.5.2 Scholarly Study on Startup Tax Incentives in India

Scholarly interest in startup tax incentives has grown considerably since the inception of the Startup India campaign in 2016[433]. Studies have examined the effect of the Startup India program on employment, investment, and startup registrations; most such studies find positive effects on all these fronts. Geographic and sectoral concentration in incentive provision might turn out to be much narrower than policymakers anticipated, based on the findings of a number of studies that have pointed to a concern that startups might become concentrated in only a few cities and sectors.

The issue of angel tax controversy has received particular scholarly and policy focus in recent years. The angel tax problem occurred due to the application of Section 56(2)(viib) of the Income Tax Act to investments made during the startup funding stages[434]. The angel tax problem led to uncertainty among many startup investors before the regulation provided exemption from such problems; it had initially aimed at stopping any attempt to defraud the income tax law through share premium payments.

2.5.3 Comparative Analysis: Startup Ecosystems Worldwide and India

In order to evaluate the design of the tax incentive program for startups in India, a comparative analysis with the design of such programs worldwide should be considered. This comparative analysis allows gaining experience from the countries with a more developed entrepreneurial support environment and learning about strengths and weaknesses of India's framework for startups[435].

Unlike India, which offers tax incentives specifically for startups, the United States does not have separate tax provisions that target only entrepreneurs and startups. The US, with its

[433] NASSCOM Startup Report; Startup India Reports.
[434] Section 56(2)(viib) literature and policy papers.
[435] OECD, *Entrepreneurship and Taxation Policy Review*.

very advanced startup ecosystem centered in Silicon Valley, makes use of indirect tax benefits. Specifically, one such benefit is Section 1244 (Small Business Stock Loss Deduction) which allows for regular loss on selling certain types of startup stock worth USD 50,000 (or USD 100,000 if you're a married individual)[436].

The US model uses the legal environment in Silicon Valley to give second chances to entrepreneurs via Chapter 11 bankruptcy provisions, showing how the institutional setting can occasionally substitute for explicit tax breaks[437].

Another important lesson drawn from the UK model of investor tax incentives is that the effect on investor behaviour through the combination of income tax relief, capital gains relief, and inheritance tax relief can be substantially strengthened. The lesson for India would be to include this factor while framing future iterations of its start-up incentive schemes.

The Enterprise Investment Scheme and Seed Enterprise Investment Scheme (UK) may be among the most carefully thought out tax incentives offered to investors anywhere in the world. Investors can receive 100% inheritance tax relief if the shares held for at least two years qualify as EIS, 30% income tax relief on annual investment of up to GBP 1 million, and Capital Gains Tax deferral benefit on capital gains invested in EIS qualifying companies[438]. Investors get 100% Capital Gains Tax benefit and 50% income tax relief on investments up to GBP 100,000 under SEIS[439].

The evidence that indicates that Israel has been successful in creating a knowledge-driven entrepreneurial environment is plentiful. In the case of Israel, the major financial incentive comes in the form of the Law for the Encouragement of Research, Development, and Technological Innovation in Industry, which falls under the purview of the Israel Innovation Authority (IIA)[440]. The law provides grants that range from 20% to 50% of authorized R&D expenses along with a favorable payback plan based on royalty payments. Moreover, one method that has been employed to keep the skilled workforce within the technology firms includes the Capital Gains Tax exemption from the employee stock option scheme. Under the Start-up India program of the government, efforts have been made to emulate the Israeli model by emphasizing the importance of blending grant-based incentives with tax concessions and institutions for transferring technology. Taking into consideration that Singapore is located very close to India and also being economically interconnected, the way in which Singapore approaches taxation of startups is especially significant in this regard. Under the Start-up Tax Exemption (SUTE) program, Singapore gives 75 percent tax exemption for the first S$100,000 of taxable income and 50 percent for the next S$100,000 in the initial three years of assessment[441].

With regard to eligible projects, both the Pioneer Incentive and Development and Expansion Incentive provide tax incentives at reduced rates ranging between 5%-10%. Given India's complexity in defining eligible projects and optional process of DPIIT certification, it has never been easy for the Indian regime to mirror the simple approach adopted by Singapore.

"The Singapore Flip" phenomenon, which has been a concern for India since time immemorial, involves Indians shifting to incorporate businesses in Singapore owing to the ease of business and certainty on taxation[442].

Out of all the big economies, the Chinese regime seems to have adopted the most ambitious fiscal policy for fostering startup ecosystems. The High and New Technological Enterprise (HNTE), an incentive provided to

[436] Internal Revenue Code (US), Section 1244.
[437] U.S. Bankruptcy Code, Chapter 11.
[438] UK HMRC, *Enterprise Investment Scheme (EIS) Guidelines.*
[439] UK HMRC, *Seed Enterprise Investment Scheme (SEIS).*
[440] Israel Innovation Authority, *R&D Law Overview.*
[441] Inland Revenue Authority of Singapore (IRAS), SUTE Scheme.
[442] Singapore Economic Development Board (EDB) Incentives

qualifying technology enterprises, includes corporate tax rates reduced from 25% to 15% as well as 75% super deductions for research and development costs (with 100% deduction available to manufacturing companies). Large venture capital funds under the Chinese government, as well as government-backed state-controlled banks offering preferential lending to technology enterprises, make up the Chinese approach[443].

Nonetheless, the net effect on the generation of unicorns and the growth of technological industries has been substantial, despite controversies regarding the efficiency of such state-led industrial policies, with critics pointing out the problem of inefficient resource allocation and political favoritism when it comes to choosing beneficiaries. The Indian policy framework is an alternative approach that may be more sustainable, since it is market-driven and utilizes tax benefits as a form of correction.

2.5.4 Sectoral Research into the Efficiency of Tax Incentives

There is some research examining the efficiency of tax incentives within specific sectors in addition to their evaluation within the context of the economy as a whole. Such an approach becomes particularly relevant in the case of India, given that startups flourish in the financial, health tech, education, and IT sectors. Sectoral analysis provides a closer look at how tax incentives operate and in what conditions.

It seems that the structure of the sector is defined more by factors like an abundance of English-speaking technical specialists, a favorable demographic situation, and strong diaspora networks rather than tax incentives.

From studies by Athreye (2005) and Arora et al. (2012), it became clear that factor endowments and increased demand triggered by globalization, and not explicit fiscal measures, accounted for the rapid expansion of India's IT industry[444].

However, the creation of Software Technology Parks of India (STPI), which provided a tax exemption to profits made through exports as per Section 10A of the Income Tax Act before 2011, helped in developing the export-oriented structure of IT and concentrating IT enterprises in the parks allocated for that purpose. The effect of abolishing tax incentives can be assessed through the sunsetting of the STPI benefits when India moved to the Normal Tax Regime in 2011[445].

The case with fintech companies looks different. With the introduction of demonetization in 2016 and the launch of Unified Payment Interface (UPI), fintech businesses have experienced a significant increase. According to research by the Reserve Bank of India (RBI) and NITI Aayog, infrastructural investments (India Stack digital public infrastructure) and regulatory innovations (RBI's sandbox framework) played a greater role in this growth than tax incentives alone.

Nevertheless, the tax exemptions enjoyed by fintechs include the STT exemption on digital asset transactions on unlisted exchanges and Category-II AIF investments made under section 115UB.

The best example of how targeted tax incentives can help is in the biotechnology or healthcare technology sector. Traditional incentive schemes for companies or startups in the software or IT sector cannot work in the case of pharmaceutical and healthcare innovation because of the lengthy research period, large amounts of capital invested, and the uncertain economic outcome that follows. The principal incentive offered to promote innovation in this field is the tax relief provided for under section 35(2AB) where R&D expenditures on approved internal R&D facilities are given as a weighted deduction. The rationalization of the deduction from 200% to 100% with effect from AY 2021–2022

[443] China Corporate Income Tax Law; HNTE Regulations.

[444] Athreye (2005); Arora et al. (2012).

[445] Income Tax Act, 1961, Section 10A; STPI Scheme.

has been seen as a retrograde move and a setback to the growth of the biotechnology sector in India.

Another growing field where startups can flourish and tax policy can be designed is agriculture technology or agritech. Given that Section 10(1) of the Income Tax Act excludes income earned through agriculture from income tax, agritech startups that earn revenue through agriculture-related ventures have to navigate a complex taxation scenario where their revenue from technology services would be taxable while their main source of income may be excluded[446]. There is an academic focus today on designing a coherent tax regime for agritech startups that takes into consideration the heterogeneous nature of the revenue streams of such startups without distorting business models by way of perverse incentives. It appears that the Budget 2023 plans to recognize DPIIT startups in climate tech and agritech sectors is a positive move in this direction.

2.5.5 The Political Economy of Tax Incentives for Startups

The political economy approach to tax incentives for startups adds great value to the largely economic approach that dominates most of the literature in this field. Tax concessions for startups are not crafted in an ideological vacuum; they highlight the interplay of diverse interest groups like government departments with their own mandate and institutional considerations, existing industrial lobbies (NASSCOM and CII), venture capitalists, angel investors, and founders/entrepreneurs of startups. The DPIIT's mandate to foster entrepreneurship and the objectives of the Ministry of Electronics and Information Technology regarding 'digital India' could be incompatible with the overriding focus on revenue neutrality and non-avoidance on the part of the Ministry of Finance. Historically, these institutional rivalries have resulted in the crafting of tax statutes that strive to achieve multiple objectives, though none optimally.

In keeping with the insights drawn from the public choice literature (see Buchanan & Tullock, 1962), well-connected industry lobbyists are likely to employ tax concessions as a strategy for seeking rents by influencing policies in ways that favor their interests. Indeed, according to empirical evidence from India, English-educated entrepreneurs have reaped maximum benefits from tax exemptions for startups in the cities, even as entrepreneurial talent in the villages and informal sector continues to be left out.

Moreover, the political economy analysis stresses the importance of credible and stable policy-making. The policy-making uncertainty may arise as a result of the frequent modifications to the startup taxation policies, including the implementation, amendment, and subsequent phase out of the angel tax policy within a span of twelve years between 2012 and 2024. Due to the long-term decisions made by venture capital funds and institutional investors, credibility becomes particularly important for tax policies. In addition, similar to macroeconomic policy, where the commitment problem introduced by Kydland and Prescott (1977) can occur despite having efficient policies, inefficient tax policy arises due to its time inconsistency. Time inconsistency occurs because what is optimal ex ante may not necessarily be optimal ex post.

Another layer of complication comes from the federal nature of Indian politics. While Schedule VII of the Indian constitution provides an emphasis on the corporate income tax policy, the state government has the power to levy many other startup-related taxes, such as the stamp duty on share transfers and registration, elements of the SGST, and other local taxes.

Startups will have to operate within the challenging terrain of fiscal federalism, created by the dynamic interaction between federal and state-level incentive systems. The terrain can either provide opportunities (competitive

[446] Income Tax Act, 1961, Section 10(1)

federalism, which might foster good policy experimentation) or obstacles (compliance costs, and inconsistent treatment among states).

2.5.6 Economic Growth, Innovation Indicators, and Tax Incentives

How startup tax incentives produce tangible growth in innovation indicators and lead to economic growth in the end is a critical issue in the literature. That requires moving from input measures (such as attracting venture capital) to output measures (such as GDP contributions, job creation, efficiency gains, and patent filings).

Among the most commonly used innovation output measures are patent counts. The data from India show that when the Startup India initiative was introduced in 2016, a clear spike in patent filings followed. For instance, in the financial year 2023–2024, the Indian Patent Office (IPO) registered close to 90,300 patent applications, compared to only around 45,000 applications in FY 2015–16.

In contrast, the simultaneous deployment of various policies, such as changes in patent laws, faster examination for DPIIT firms, and increased awareness regarding IP protection, makes it difficult to assess the causality between tax incentives and patent application filing.

The best approach to measuring the economic effect of startup tax incentives would be the total factor productivity (TFP) growth, which captures how efficiently inputs are converted into outputs and represents the main source of sustained economic growth. Because of a lack of data, the estimation of startup impact on TFP growth in the country has remained limited up to now. NSO's approach to calculating the national accounts system does not take into account the contribution of the DPIIT-recognized universe of startups to TFP growth.

That being said, research at an industry level has revealed that the pharmaceutical, financial services, and IT sectors, where there are high concentrations of startups, have been experiencing higher-than-average rates of TFP growth.

For a labor-surplus nation such as India, job generation remains the most important politically relevant statistic that reflects the impact of tax benefits for startups. According to the DPIIT, by 2024, startups recognized under its scheme have provided more than 1.2 million jobs directly. It is essential to note that majority of the working population in India is still engaged in the agricultural sector or in informal activities. Direct employment at startups that are capital and technology-intensive is relatively more capital-intensive and involves higher skill levels in labor.

The tax system will have to create incentives for startups to reach beyond the narrow segments of the economy in order to contribute towards their development, such as developing labor-intensive processes, platforms for gig workers, and innovation in the agricultural sector.

2.6 Gaps in the Existing Literature

Several gaps continue to exist within the body of growing literature on Indian incentives for startups and their associated economic benefits. First, in addition to the documentation of the observed correlation between the changes in tax policies and observable phenomena, there is a dearth of empirical studies which have attempted to establish a cause-and-effect relationship between some tax-related provisions and startup establishment, investment behavior, and economic outcomes. Second, the issue of whether the incentives provided under different tax incentive schemes benefit predominantly affluent businessmen and investors or are accessible by people from all social strata remains unaddressed in the existing literature. Finally, there are not enough works addressing the issue of how the incentive mechanisms established by the Indian government compare with international best practices. Through its comprehensive and sound analysis of the tax incentives provided to Indian startups and

investors, this dissertation intends to fill these research gaps[447].

Apart from the above three shortcomings of the existing literature review, some other gaps have been identified in this literature review. Firstly, the effects of interactions among different tax incentive programs are not explored sufficiently by the existing literature base.

For example, sections 80-IAC (tax holiday), 54GB (capital gains rollover), and 56(2)(viib) (angel tax) form a set of interactions where the combined effect of such interactions on the behavior of investors could be very different from the individual effects. What is needed for the analysis of the interaction effect among different types of tax incentives is an integrated system approach to the design of tax incentives that is currently missing in the existing literature.

Finally, there is not much literature on the temporal dynamics of the use of tax incentives by startups. The existing literature mostly provides static analyses of the linkages between fiscal incentives and startups, but fails to provide insights into the changing efficiency of incentives over time as the startup ecosystem grows. At the early stage of development of the ecosystem when market failures are acute and institutions are underdeveloped, fiscal incentives are most crucial. But as soon as the self-sustaining relationships develop between capital, talent, and technology within the ecosystem, such incentives become increasingly less important. This aspect of the issue seems especially topical now since we see that India is entering an important phase in the evolution of its startup ecosystem.

Sixth, with respect to India, very little literature exists on how the gender dynamics affect startups' ability to access tax incentives. Given the fact that there is severe underrepresentation of women founders among startups included in the DPIIT list, which according to various estimates is in the range of 15% to 18% as of 2023, it becomes essential to understand whether there is any element in the formation or implementation of tax incentive programs that may directly or indirectly foster these structural inequalities. Data from the United Kingdom shows that besides the fact that the gender gap in the use of SEIS/EIS is partially linked to features of the scheme (such as complex criteria for the grant of tax incentives) making it particularly difficult for women who lack professional advice, it is partially due to gender inequality in financing ventures.

Finally, another research gap relates to the sustainability and environmental dimensions of startups' access to tax incentives. The discussion about how to redesign tax incentives for startups in order to focus on the emerging climate-tech and clean-energy startups has become a vital one, as India has promised the world that it will reduce its net-zero carbon emissions to zero by 2070 and also boost the use of non-fossil energy up to 50% by 2030. Other than limited tax incentives for electric vehicles (EVs), there is nothing else under the present incentive system in the Income Tax Act of India that has an environmentally-oriented component.

Thus, this dissertation will make a valuable contribution through a comprehensive assessment of the process of integrating environmental tax incentives for startups into India's tax regime through global frameworks such as the European Union's Innovation Fund and the US Inflation Reduction Act's clean energy tax incentives.

To conclude, numerous research gaps regarding methodology, distribution, comparison, history, gender, and environment will be covered in this dissertation, which will contribute positively to the existing scholarship related to startup tax incentives in India. This will ultimately allow for the formulation of policy recommendations for the design of a next generation incentive system.

[447] Appelt et al. (2016); OECD comparative studies.

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2.7 The Conceptual Framework of the Study

This part presents the conceptual framework that guides the analysis performed in the current dissertation, relying on the theoretical positions and empirical literature presented earlier. This framework builds on four theoretical foundations: market failure theory, optimal taxation theory, institutional economics, and entrepreneurship theory, providing a conceptual structure that can effectively deal with the complex issues associated with startup tax incentives in India.

Market failure theory provides a basis for state involvement via tax incentives as its first theoretical foundation.

Information asymmetries, which lead to insufficient investment in innovations; external benefits of innovations, leading to socially suboptimal investment in R&D; and the non-diversifiable character of Knightian uncertainty, which leads to overly high rates of return required for investments in innovative startups are the three major market failures discussed in Section 2.3. Although they give some grounds for state intervention in the sphere, market failures cannot determine what type of actions should be undertaken. It is an empirical issue whether or not one should prefer direct grants, tax incentives, venture capital, and regulations as intervention instruments.

The second principle, optimum taxation theory, sets criteria for evaluating the effectiveness of tax incentives. Optimal tax incentives must aim at minimizing deadweight loss, taking into account any externality, in accordance with the Ramsey-Diamond-Mirrlees approach. As far as start-up companies are concerned, it implies that tax incentives should be oriented towards those activities which generate strong externalities (such as fundamental research and creation of new platforms), and they should be aimed at minimizing compliance cost (thereby enhancing the benefit from the incentives for small firms), while being subject to time-limited sunset clauses.

Finally, entrepreneurship theory serves as the fourth principle underlying our analysis of start-up companies' response to tax incentives. Based on the Kirznerian concept of entrepreneurship as a process of discovery of economic opportunities in a state of disequilibrium, one could argue that tax incentives may be more effective in stimulating high-quality startups, as opposed to an increase in their quantity due to the necessity to choose those projects that would not have been chosen due to low expected social returns.

The Schumpeterian perspective on the process of creative destruction emphasizes the importance of designing appropriate incentives to foster new entries because the very fact that there might be certain incentives that aim at protecting incumbent firms in the form of extended tax holidays and loss carry-forwards will diminish the competitive pressure that leads to innovation.

The efficiency of the incentive structure of Indian tax policies for startups depends not only on the nature of incentives (tax rates, duration, etc.), but also on the environment within which the policies operate, including behavioral responses to the design of such incentives and the distribution of the benefits of the incentives among various sectors and regions in India. This is the main idea underlying all four theoretical frameworks above.

In fact, it is precisely due to such a multifaceted approach that allows the research of this dissertation to contribute to both theoretical knowledge and practical policymaking in this area by finding out when such a framework works well and when it fails and what changes can be introduced to improve it.

2.8 Summary

The relevant literature on tax incentives for entrepreneurs and investors in India was reviewed extensively in this chapter. After discussing the conflicting views on the concept of startups and the implications for tax policies, the chapter focused on the economic rationale

for government intervention using tax incentives, such as market failure, positive externality, and Knightian uncertainty. Following that, it analyzed the different types of tax incentive instruments adopted by India, including profit exemptions, capital gains exemption, deferred taxation of ESOPs, and the controversial angel tax, providing an assessment of their effectiveness, implementation challenges, and rationales.

In reviewing the literature, the study explored not only the expanding body of Indian studies on the Startup India initiative and its fiscal features but also the international literature on tax incentives for research and development and entrepreneurship. Comparing India's tax incentive regime with that of the United States, the United Kingdom, Israel, Singapore, and China provided insights into the essential design features that were missing from the Indian regime and vice versa.

Whereas the political economy analysis highlighted the institutional and political constraints that shape both the design and delivery of incentives, the sectoral literature focused on the differential impact of tax incentives within the varied Indian startup landscape.

The present thesis seeks to address six distinct research gaps, which include causal inference issues, concerns regarding distributive justice, international comparisons, complementary interactions of incentives, temporal effects, gender considerations, and sustainable development. Market failure, optimal tax theory, institutional theory, and entrepreneurship theory are all incorporated into the framework explained in Section 2.7, thereby creating a coherent theoretical foundation for subsequent empirical analysis in Chapters 3 and 4. This combination of theoretical and empirical foundations is what makes the current thesis particularly well-suited to make a significant contribution to knowledge about the proper use of tax policy for the promotion of India's startup ecosystem.