iLINC Policy Briefs

Tax Regulation and the Start-Up Community

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ICT Law Incubators Network

Digital start-ups have limited funds. Nevertheless, even at an early stage, taxes need to be paid. This could drain valuable resources early on. Additionally, EU digital start-ups worry about the rising compliance costs due to the newly implemented VAT regime. The introduction of tax relief could provide start-ups adequate breathing space during the first years of development and could positively affect third-party investment. Sharing best practices among Member States and benchmarking national tax laws could improve the overall efficiency of such regimes.

Why Consider Start-up Tax Relief?

If digital start-ups are considered to be a driver for innovation, adequate space is needed for these technology enabled businesses to grow. Some national tax regimes however, may already suffocate promising ventures at an early stage.

The iLINC survey indicates that digital start-ups have limited funds available and that acquiring the necessary funds to develop technologies can be difficult. Nevertheless, even at a start-up stage taxes have to be paid. This may drain much needed funds during early development. Favourable tax policies at the seed-stage could nonetheless benefit high-growth and high-job generating sectors. iLINC therefore recommends policymakers to consider tax relief for start-ups as this would have an immediate, positive effect on their available budget.

Recommendation 1: Member States should consider the implementation of favourable tax regimes for the start-up sector.

The need for tax benefits is also a recurring theme in the various start-up manifestos, both from the start-up's and investor's perspective.

The Entrepreneur's Perspective

Tax exemptions would allow start-ups to direct their money and attention to the development of their idea and business. A 2007 EU Study has shown that tax compliance costs constitute one of the most important elements in general regulatory compliance costs.[2] The reduction of tax compliance costs could improve the start-up ecosystem: **complex tax legislation and reporting procedures place a heavy burden on newly found ventures who, due to their limited resources and experience, often face higher compliance costs.[3]**

The Investor's Perspective

Tax relief could incentivize the reallocation of funds to sectors that would otherwise be deemed too high-risk. Only half of the European unicorns have reached a sale or IPO, compared with two-thirds in the United States. Digital Single Market Vice-President Andrus Ansip agrees that this may suggest the European environment to be more challenging for technology investments. Many EU start-ups currently seek funding outside the EU. However, this may require the start-up to move to the country where the funds comes from. In other words, a lack of investment incentives may give rise to a digital brain drain.

"Positive discrimination of SMEs, and in particular of high-growth businesses, will increase the capital efficiency of investments performed at these early stages, especially in the first years of its creation." – The Start-up Investors Manifesto

Balance

A balancing act will still be required: "The benefits of introducing reduced corporate tax rates for specific firms need to be weighed against the potentially increased costs in terms of tax compliance and possible disincentives to grow."[7]

Recommendation 2: If Member States do employ tax discrimination, the procedure to benefit should be start-up friendly, i.e. have low compliance costs.

Tax Relief in Europe:

Recommendation 3: Exchanging best practices among Member States and benchmarking national tax laws could improve the efficiency of national EU tax schemes.

After the crisis, many Member States introduced changes to the tax base in order to increase competitiveness, stimulating investment and entrepreneurship.

Member States have already introduced tax measures in order to boost entrepreneurial activity and investment in small unquoted companies, while other Member States expanded on their existing tax incentives for early stage undertakings.

The following EU countries may serve as an example for other Member States who wish to introduce a tax shelter for start-ups. These systems may stimulate entrepreneurship through investment relief (UK), start-up tax breaks (Latvia) or through both (Italy). In Belgium, a specific start-up tax shelter system is in the works. iLINC does not favour one tax regime over the other. The implementation of tax relief is very much dependent from Member State to Member State. Nevertheless, **sharing best practices could provide valuable insight on how to best regulate taxes in the start-up environment.**

United Kingdom

London is one the world's leading start-up capitals. In the Start-up Europe Manifesto, **the EU start-up community has referred to the UK's Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) as a potential tax relief model to stimulate investment in high-risk companies.** The EIS aids smaller higher-risk trading companies in raising finance, offering up to 30% in tax relief for those investors purchasing new shares in qualified companies. Similarly, the SEIS is designed to help small, early stage undertakings raise equity finance by offering tax relief to individual investors who purchase new shares in those companies at a 50% rate.

Latvia

The Latvian Chamber of Commerce and Industry developed the 'Think Small First' initiative to counteract the economic crisis. The initiative promoted the creation of a special tax rate and simplified the existing accounting system. In 2010, Latvia instated the Micro-Enterprise Tax Law, which introduced a flat tax rate of 9% for micro businesses. The initiative was awarded the Grand Jury Prize during the 2013 European Enterprise Promotion awards. The introduction of the 'micro-enterprise' concept has enabled Latvia's rapid economic growth within the EU.

Italy

In Italy, tax measures were implemented to facilitate the growth and emergence of innovative start-ups. Start-ups with an intensive research and development process are subject to more favourable tax treatment. Furthermore, tax breaks for investments made by companies and individuals were introduced to benefit the private equity market. **Fiscal benefits are even higher when investments are made in start-ups with a social goal** or start-ups that develop high value technological products in the energy sector.

Belgium

The Belgium government's 'Start-Up Plan' will launch a **start-up specific tax regime**. Fiscal incentives will be introduced to **encourage both start-up and digital investments, stimulate crowdfunding and facilitate hiring**. A tax shelter will be implemented to attract investors. The investment incentive will consist out of a tax reduction on the investor's personal income. The digital investment scheme is aimed at start-ups themselves, and would encourage start-ups to invest in digital assets, such as e-payment methods and cybersecurity. Crowdfunding, under certain circumstances, would be more appealing due to the implementation of tax exemptions. Finally, hiring employees should be more attractive as labour costs would be reduced during the first years of development.

Start-ups and the newly adopted VAT regime

Digital start-ups worry about the consequences the newly adopted VAT regime may have on their business. Due to the new VAT regulation, VAT liability for digital products is now determined by the country where the product is bought, rather than the place of supply. This means that start-ups offering digital goods must now take into account the VAT regimes of the 28 member countries. Digital start-ups fear that this may place a heavy burden on their shoulders. They feel that they are being penalised, while businesses offering physical goods remain unaffected.

"The government should be making it easier for start-ups and freelancers to sell across Europe, but the new VAT rules may do the opposite. It's vital that the government looks again at what it can do to protect sole traders and small businesses from the burdensome impact of these changes."- Guy Levin, COADEC[6]

This concern may not be entirely unfounded. The recently adopted VAT regulation was drafted six years ago and was aimed to avoid global companies, such as Google and Amazon, from paying fewer taxes in tax-friendly countries as Luxembourg and Ireland. Since then, the digital landscape has changed however. A recent survey organised by Nesta suggests that a great majority of **start-ups consider the changes in VAT regulations as a significant inhibitor to cross-border activities.** Numerous start-ups feel that regulatory changes, such as the VAT rules, have been implemented without their consultation.

Even though, the VAT mini-one-stop-shop (MOSS) allows start-ups to account for the VAT due via a web-portal in the Member State of their establishment, for start-ups selling digital products this isn't optional and they will have to register with a MOSS, regardless of their turnover. Recent EU figures indicate that the current VAT regime has increased compliance costs considerably. **Online businesses who wish to trade in other EU countries face an annual compliance cost of 5000€ for each Member State in which they wish to provide their goods or services.[12]**

The need to simplify current VAT arrangements has now been recognized by the European Commission as well. **Nevertheless, the efficiency of simplification measures is dependent on the inclusion of start-ups, and digital start-ups in particular, in the drafting process.**

Recommendation 4: When drafting future simplified VAT arrangements, the voice of start-ups must be taken into account, as well as the potential impact of these measures on digital entrepreneurship.

iLINC Recommends

- Member States should consider the implementation of favourable tax regimes for the start-up sector.

- If Member States do employ tax discrimination, the procedure to benefit from it should be start-up friendly.

- Exchanging best practices among Member States and benchmarking national tax laws could improve the efficiency of national EU tax schemes.

- When drafting future tax legislation, the voice of start-ups must be taken into account, as well as the impact this legislation may have on digital entrepreneurship.

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ILINC is the European Network of Law Incubators. Its main objective is to facilitate the provision of free legal support to start-ups while, at the same time, offering postgraduate law students the opportunity to engage in professional practice in the fast-moving and highly exciting world of technology start-ups.

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