

Regulatory Hotline

January 25, 2016

GOVERNMENT TRIES TO DISRUPT REGULATORY HURDLES; A GOOD FIRST STEP BUT STARTUPS WANT MORE

On India's Independence Day the Prime minister of India announced that the Government intended to launch an initiative titled "Startup India, Stand up India" to encourage entrepreneurship among the youth.

As the first step to this initiative, a full action plan for Startups in India was launched by the Prime Minister on January 16th, 2016 ("Action Plan") in New Delhi. This Action Plan sets the stage for wide ranging reforms which are expected to give an impetus to the fast burgeoning startup culture in India.

The Prime Minister whilst announcing the Action Plan, once again reiterated his Government's intention of '*less government more governance*' where he attempted to reduce the regulatory hurdles for starting up a business in India.

We had organized a webinar on January 20, 2016, where we analyzed key changes that are proposed to be introduced by the Action Plan and its implications on startups and investors. For those of you who were unable to attend, you may access the video of the webinar at [Nishith.TV](#).

CHANGES

Whilst we await the official notification and text of the changes proposed by the Prime Minister, our analysis on the key legal and tax changes is as follows:

A. Definition of Startup

Though initial news reports suggested that certain sections of the Government did not want to define 'startups' for the worry of it being an impediment to a new and revolutionary idea. The Action Plan nevertheless provides for a definition of startup:

- An entity (i.e. a private limited company / limited liability partnership or a registered partnership firm) incorporated / registered in India not prior to five years and with annual turnover not exceeding INR 250,000,000 (approximately USD 3,687,810) in any preceding financial year, working towards innovation, development or commercialization of new products, processes or services driven by technology or IP;
- A business would be covered under this definition only if it aims to develop and commercialize:
 - A new product or service; or
 - Significantly improves an existing product, service or process that will create and add value for customers or the workflow
- The mere act of developing the following would not be covered under this definition
 - Products or services which do not have potential for commercialization; or
 - Undifferentiated products or services or processes; or
 - Products or services or processes with no or limited incremental value for customers or workflow.
- In order for a start up to be considered as eligible it should:
 - Be supported by a recommendation, with respect to the innovative nature of business by an incubator, established in a post graduate college in India; or
 - Be supported by an incubator, which is funded by the Government of India to promote innovation; or
 - Be supported by a recommendation, with respect to the innovative nature of business by an incubator, recognized by the Government of India; or
 - Be funded by an incubation fund / angel fund / private equity fund / accelerator / angel networks, duly registered with the Securities Exchange Board of India that endorses the innovative nature of the business; or
 - Be funded by the Government of India to promote innovation; or
 - Has a patent granted to it in areas which the Government is promoting.

Most importantly, a startup will be eligible for tax benefits only after it has obtained certification from an inter – ministerial board setup by the Department of Industrial Policy and Promotion, Ministry of Commerce & Industry, Government of India for such purpose.

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It has been clarified that to be considered as a startup for the purposes of the aforementioned definition, the entity should not be formed by splitting up or reconstruction of an existing business.

Further, the benefits would cease to apply once the turnover of the entity exceeds INR 250,000,000 (approximately USD 3,687,810) or it has completed 5 years from the date of incorporation;

Our View

As per this definition, for an entity to be considered as a startup, it would be required to be incorporated / registered in India not prior to five years, and with an annual turnover not exceeding INR 250,000,000. It is not clear whether this definition would apply only to entities that have been incorporated after these changes have been notified, or would even extend to existing entities. In our view, this definition should apply to existing startups as well, which fulfil these criteria.

However, the definition also contains a requirement that the startup should be “*working towards innovation, development or commercialization of new products, processes or services driven by technology or IP*”

Whilst the definition lays down broad principles that the Government would keep in mind when deciding on whether a business is innovative, it also provides the requisites for a startup to be considered as eligible, such as: (a) a recommendation from an incubator in a post graduate college in India; or (b) a recommendation from an incubator funded by the Government to promote innovation; (c) a recommendation from or an incubator recognized by the Government; or (d) a recommendation from an incubation fund / angel fund / private equity fund / accelerator / angel network that has funded such business as to the inventive nature of the business; or (e) been funded by the Government to promote innovation; or (f) been granted a patent in a field that the Government is promoting.

Therefore, clarity would be required as to whether, as a matter of process, would it mean that only once the entity receives a recommendation from any of the above it would qualify to file an application to the inter – ministerial board or could it also independently apply to the board asking for its approval.

Fundamentally, one the biggest issues under the Action Plan is the fact that, it is not clear as to whether an entity would require such certification to avail of all the benefits laid out under the Action Plan. Or whether this certificate is only required to avail tax benefits, where the other benefits may be obtained without approval from the inter – ministerial board. Therefore, clarity would be required from the Government as to scope of the definition.

Specifically, the approval process brings about subjectivity in what business would be categorized as ‘innovative’ and to what extent will it be eligible for benefits. For example, if the business model is tried for first time in India but is based on a global business model that has become successful, would it still be considered as innovative? Similarly, if there is a pressing local problem, typically there would be more than one startup that would try to solve it. Then the question would arise as to whether all such startups would be considered as innovative or would the startup that applied first be granted approval? Additionally, the requirement for having a patent would also defeat the entire purpose of providing an exemption since it typically takes 3 years or more for the grant of a patent. Similarly, a startup requires the most amount of assistance till such time that it has the support of incubator or VC fund. Based on the requirement for a recommendation by an incubator or VC fund several startups would find it difficult to be eligible. In our view there are several issues that would need to be addressed before we see benefits flowing to startups.

We believe that requirement for approval by an inter – ministerial board will create an unnecessary hurdle in the process of setting up a business. Since this approval process effectively empowers a government board to certify whether a business is eligible for tax incentives / government schemes it may also give rise to allegations of impropriety in the decision making process. Therefore, this entire process should have been automated rather than this board which we believe goes against the spirit of the Action Plan.

Although, the fact that the Action Plan does not mandate a startup to be Indian owned and controlled, to be eligible to claims benefits is a positive move. Unless the Government clarifies otherwise, this may incentivize global startups / founders to setup research and development focused subsidiaries in India to claim of these benefits.

B. Incorporation & Other Formalities

Realizing the inefficiencies in the existing systems causing inordinate delays in the incorporation of entities as well as the fact that startup founders at most times are simply unaware of the various formalities involved in starting a business. The Government in order to ease the incorporation process, would be setting up a mobile application as well as a dedicated web portal whereby:

1. A simplified form can be filled for registration of startup with various governmental agencies. Importantly, this mobile application would be integrated with the Ministry of Corporate Affairs for seamless integration;
2. A checklist of various applicable laws and licenses would be provided for founders to know of various compliances;
3. Filing for compliances and obtaining information on the status of various clearances and approvals would also be possible on the app.

Our View

Incorporation of an entity in a single day has long been a demand of the industry. This request was also recognized by the Prime Minister whilst announcing these changes. While we will have to wait to see the actual changes proposed, there are several practical issues which will also need to be simultaneously addressed. For example, most documents submitted to the Registrar of Companies usually require the affixation of a digital signature. This would need to be modified for a mobile application. Similarly, considering the fact that first time entrepreneurs would in all likelihood require a “Directors Identification Number” and the “Digital Signature Certificate”, this process also needs simplification. Additionally, the possibility of getting a live status update on the status of various clearances and approvals would greatly reduce the current ambiguity associated with such processes.

One suggestion that the Government may consider is to permit readymade ‘*off the shelf*’ companies that may be formed by a class of regulated professionals which can be simply acquired by entrepreneurs. Such a company would enable an entrepreneur to immediately commence business as opposed to waiting for the incorporation of an entity.

This concept is increasingly becoming prevalent in various jurisdictions across the world and if implemented, would provide a major fillip to the startup ecosystem in India.

C. Self-Certification

In recognition of the fact that labour and environment law compliances are time consuming in nature and that startups are often caught unaware as to the issues pertaining to such laws, the Government has proposed a self-certification mechanism for certain compliances. Under this initiative the Government would be setting up a mobile application as well as a dedicated web portal where startups can complete this self-certification process.

1. Labour Laws –

It is proposed that there will be no inspection for a period of 3 years for entities that self-certify compliance, unless instances of specific violations are reported. Even in such a case, approval from a senior officer would be required prior to any inspection. The following labour laws have been covered under this initiative:

1. The Building and Other Construction Workers (Regulation of Employment & Conditions of Service) Act, 1996
2. Inter – State Migrant Workmen (Regulation of Employment & Conditions of Service) Act, 1979
3. Payment of Gratuity Act, 1972
4. Contract Labour (Regulation and Abolition) Act, 1970
5. Employees' Provident Fund and Miscellaneous Provisions act, 1952
6. Employees' State Insurance Act, 1948

2. Environment Laws

Startups which fall under the 'white category' (as defined by Central Pollution Control Board) would be allowed to self-certify compliance and only random checks would be undertaken to ensure compliance.

1. Water (Prevention & Control of Pollution) Act, 1974
2. Water (Prevention & Control of Pollution) Cess (Amendment) Act, 2003
3. Air (Prevention & Control of Pollution) Act, 1981

Our View

Constant harassment from labour inspectors has been a long standing grouse of various businesses. To address this issues as well as reduce the overall touch points between government officials and businesses the self-certification scheme is a welcome step. This self-certification scheme comes on the back of the Maharashtra Government introducing a similar Self-Certification-cum-Consolidated Annual Returns Scheme in 2015 which covers 16 laws and has already seen significant success. Similarly, since the 'white category' as demarcated by the Central Pollution Control Board anyway does not require consent to operate, this self-certification is a step in the right direction.

However, as a startup, the difficulty in most cases arises with complying with these laws in the first place with self-certification for compliances being secondary. Specifically, there are onerous compliance requirements under other laws for example the Companies Act, 2013. In our view, not all compliances are critical for startups (as they tend to be much smaller in size), the Government should therefore exempt startups from all but few critical compliances. We hope that the Government will look at these points next.

D. Intellectual Property Rights

The Government recently announced that about 2,46,000 patent applications and 5,32,000 trademark registrations were pending with the government due to shortage of manpower. To address this backlog, at the Action Plan it was announced that the Government was recruiting various patent and trademark examiners to reduce the huge back log of pending applications. In addition, the Action Plan proposes a 1 year pilot program under which:

1. Patent applications filed by startups would be fast tracked for examination and disposal;
2. The Government will empanel facilitators who would be responsible for providing startups with (a) general advisory on intellectual property rights; (b) filing and disposal of applications dealing with patents, trademark and design. The Government would pay fees to facilitators and startups would only be required to pay statutory filing fees;
3. Startups would be given an 80% rebate in filing of patents;

Our View

This is a great move by the Government will be very helpful for startups.

E. Public Procurement

Effective from April 1, 2015 the Central Government, State Governments and Public Sector Undertakings are mandatorily required to procure at least 20% from Micro, Small and Medium Enterprises ("MSME").

In order to promote startups in the manufacturing sector, the Government shall exempt the requirement for startups to show prior experience and / or turnover as a criteria to be selected. However, there shall be no relaxation in relation to quality or technical parameters. Further, such startup must also have their manufacturing facility in India.

Our View

We believe that this is a commendable step and has the ability to allow Indian startups to come up with indigenous solutions to work alongside the Government to address local issues / problems. However, we hope that this exemption is not restricted only to manufacturing and also extends to the services sector.

F. Ease of Winding Up

The Government has already introduced the Insolvency and Bankruptcy Bill 2015 in Parliament to fast track the voluntary closure of business

Startups with simple debt structures or with the criteria that may be set out by the Government, may be wound up in 90 days from date of making an application on a fast track basis. In such a case, an insolvency professional shall be appointed who shall be responsible for liquidating its assets and paying its creditors within 6 months.

Our View

Whilst this is a welcome step, the Insolvency and Bankruptcy Bill 2015 provides for a timeline of 90 days calculated from the insolvency commencement date. Therefore, timelines for making an application to the National Company Law Tribunal and the Regional Director / Registrar of Companies till such time that the National Company Law Tribunal is notified would also need to be factored.

G. Capital Gains

To promote investments into startups by mobilizing capital gains arising from sale of capital assets. The Government has proposed an exemption from capital gains tax in the year for those who have invested such capital gains in funds of funds recognized by the Government.

Further, currently capital gains exemptions have been provided for investment by individuals in newly formed manufacturing MSMEs. This exemptions shall also be extended to all startups. I.e. currently an entity needs to purchase 'new assets' from the capital gains to avail of such exemption. It is proposed that the definition of 'new assets' would be expanded to provide for computers and computer software to promote tech based start ups

Our View

Both the exemptions provided in relation to startups do not provide any exemption per – se for investors in startups, they however do provide an incentive to people who may have made capital gains from other sources to invest such gains into startups.

The first proposed exemption provided for capital gains invested into funds of funds would in all likelihood only apply to angel investors since venture capital and private equity funds typically are required to upstream their gains / exits to investors in most cases. If that is the case, this exemption may end up having limited benefits.

Further, currently Section 54(GB) of the Income Tax Act, 1961 provides an exemption if an investor invests capital gain from the transfer of a residential property for subscription of equity shares of an eligible company which utilizes such investment amount for purchase of a new asset. We have presumed that this section is proposed to be expanded to include startups as an eligible company and which must purchase computers or computer software as a new asset from the investment received to avail of this benefit.

Under the current regime the investor is required to hold the shares of such MSME company for a period of 5 years to avail of this benefit as well as the fact that this benefit is due to expire in March 2017.

Therefore, in both cases, investors who re-invest their gains into the aforementioned sectors would essentially be able to claim a tax deferral since they would in any case be charged gains at the time that they dispose off the instrument in which they have invested their primary gains.

H. 3 Year Tax Window

With a view to promote the growth of startups as well as address working capital requirements, startups have been exempted from paying income tax for a period of 3 years. Such exemption however, is subject to non – distribution of dividend by the Startup.

Our View

Even though this appears to be a major relief, in reality this would benefit only a minute portion of the startups since most startups do not end up earning any taxable income in their first three years. Nevertheless, for startups that do earn taxable income this would help ease working capital requirements.

I. Section 56 Exemption

In the event that a company receives consideration for issue of shares in excess of fair market value of such shares, such excess consideration is taxed in the hands of the company as income.

Currently, the Income Tax Act, 1961 provides that this section would not apply where the consideration for issue of shares is received by a venture capital undertaking, from a venture capital company or a venture capital fund.

Therefore, the exemption is now proposed to be expanded to include incubators in relation to their investment in startups.

Our View

Incubators traditionally have played the role of mentoring and providing other forms of support and assistance to startups. While incubators have also started funding startups, however, angel investors in most cases provide seed capital.

Typically incubators are limited in terms of their reach by not primarily being in the business of investing into startups but also of providing other services, whereas, angel investors are able to provide risk capital as well as mentorship in some cases across a wider spectrum of companies. Therefore, we believe that it is essential that this exemption is not only restricted to incubators but is also extended to angel investors.

FUTURE CHANGES

While the first steps have been taken in the right direction there are several areas which need to be addressed. We have provided the items requiring immediate attention and which are easy to achieve below:

ESOPs

Currently the Companies Act, 2013 places several restrictions on the grant of stock options. Considering the fact that there are several stake holders in the growth of a startup, greater flexibility is required to ensure that mentors, directors, advisors etc. are allowed to be granted stock options.

Additionally, ESOPs are currently taxed at the time of exercise which makes it very burdensome for employees. Therefore, ESOPs should ideally be taxed only at the time of sale which is when most employees are ever able to see an exit.

Venture Capital Investment

The Reserve Bank of India in and around the year 2008 started imposing conditions on Foreign Venture Capital Investors ("FVCI") in their permissions whereby they were allowed to invest only in 9 (nine) sectors. These sectors have remained unchanged for nearly 8 years now and internet based businesses are difficult to categorize in terms of the sectors they fall under. We would suggest that the FVCI regime should be overhauled just to provide for a list of prohibited sectors as opposed to permitted sectors. Most importantly, at a minimum, the list of approved sectors should also include the definition of startups as laid down by the Government, subject to them not falling within the list of restricted sectors.

CONCLUSION

The underlying motto of the launch of the Action Plan was that of 'We unobstacle' which was echoed by the Prime Minister himself who mentioned that for startups to flourish in India it was necessary for the Government not to over regulate. The Government seems serious about stemming the exodus of its startups to foreign shores and to that extent appears to be receptive to suggestions from the industry.

For the past few months we have been working with various stake holders including investors, entrepreneurs, industry bodies etc. to collectively engage with the Government to provide detailed startup policy recommendations, including changes to current laws based on best practices globally which are available at <http://startupbridgeindia.com/>

We believe that the momentum set into motion by the launch of the Action Plan should be sustained and we hope for some additional reforms to be notified in the Union Budget. Ensuring speedy implementation of these reforms is going to be critical to ensure that the Government's vision of creating more unicorns and have them list in India as opposed to the NASDAQ/NYSE.

– Kartik Maheshwari & Vaibhav Parikh

You can direct your queries or comments to the authors

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