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THE START-UP PUSH

The Government of India has launched "Startup India" – an initiative to build a strong eco-system for nurturing innovation and start-ups in the country that could drive sustainable economic growth and generate large scale employment opportunities. The Government of India through this programme aims to empower innovative start-ups and has released the "Startup India: Action Plan" dated January 16, 2016[1] ("**Action Plan**").

The Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India ("**DIPP**") took the first step in implementing the Action Plan by adopting vide notification dated February 17, 2016[2] ("**DIPP Notification**") the definition of 'Start-up' and establishing the 'inter-ministerial board' ("**IMB**"), who shall be responsible for validating the innovative nature of the business and whose certification is necessary in order to obtain tax benefits.

The DIPP Notification has defined Start-ups as entities having the following characteristics:

1. An entity must be registered either as a private limited company, partnership firm or a limited liability partnership in India;

2. The entity should not have completed 5 years from the date of incorporation or registration and shall cease to be regarded as a Start-up upon completion of 5 years from the date of incorporation or registration;

3. The annual turnover[3] of the entity for the previous financial year shall not have exceeded INR 250 Million;

4. The business objective of the entity must be to "develop and commercialize a new product or service or process, or a significantly improved existing product or service or process that will create or add value for customers or workflow".

1. Full text of the Action Plan may be accessed at: http://dipp.nic.in/English/Investor/startupIndia/StartupIndia_ActionPlan_16January2016.pdf (Accessed on March 06, 2016)

2. Full text of the DIPP Notification: http://dipp.nic.in/English/Investor/startupindia/Definition_Startup_GazetteNotification.pdf (Accessed on March 06, 2016)

3. "Turnover" has the same meaning as provided in the Companies Act, 2013. Section 2(91) of the Companies Act, 2013 defines "Turnover" as 'the aggregate value of the realization of amount made from the sale, supply or distribution of goods or on account of services rendered, or both, by the company during a financial year'.

It has been clarified that the mere act of developing products or services or processes 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 would not be covered under the definition of 'start-up'. Further, an entity established by splitting/reconstructing an existing business will not be considered as a start-up.

The DIPP Notification has laid down eligibility criteria in order to reduce the subjectivity attached to being an 'innovative start-up' The entities must submit an application form along with proof of having complied with the eligibility criteria, to be considered for being recognition as a Start-up including:

1. A recommendation, with regard to innovative nature of business, in a format specified by DIPP, from an incubator established in a post-graduate college in India; or

2. A letter of support by an incubator which is funded, in relation to the project, from the Government of India or any State Government as part of any specified scheme to promote innovation; or

3. A recommendation, with regard to innovative nature of business, in a format specified by DIPP, from any incubator recognized by the Government of India; or

4. A letter of funding of not less than 20% in equity by any incubation fund / angel fund / private equity fund / accelerator / angel network duly registered with the Securities and Exchange Board of India, that endorses innovative nature of the business; or

5. A letter of funding by the Government of India or any State Government as part of any specified scheme to promote innovation; or

6. A patent filed and published in the Journal by the Indian Patent and Trademark Office in areas affiliated with the nature of business being promoted;

The benefits of being recognized as a Start-up would largely be to take assistance of the policy proposals and schemes that may be extended by the Government of India specifically to Start-ups. The Action Plan had proposed certain benefits, some of which have also been provisioned for in the budget speech by the Minister of Finance on February 29, 2016 ("**Budget Speech**") or the Finance Bill, 2016 ("**Finance Bill, 2016**")[4]. The Budget Speech read with the Finance Bill, 2016 provides as follows:

1. Capital gains from transfer of shares of the start-up will not be taxed if the proceeds from such transfer are invested in the units of a 'long term specified asset' issued by the Government of India before April 01, 2019. This exemption is subject to the proceeds being invested in the 'long term specified asset' within 6 months from the date of such transfer, the investment is maintained for 3 years and does not exceed INR 5 Million during any financial year;

4. Full text of the Budget Speech is available at http://indiabudget.nic.in/ub2016-17/bs/bs.pdf (*Accessed on March 06, 2016*).

5. Clause 31 of the Finance Bill, 2016 and notes on clauses, provided thereof. Full text of the Finance Bill, 2016 is available at: http://indiabudget.nic.in/ub2016-17/fb/bill.pdf (*Accessed on March 06, 2016*). Amendment is proposed by insertion of new Section 54EE in the Income Tax, Act, 1961.

2. Capital gains arising on account of transfer of a residential property (including by individuals) shall not be charged to tax if such capital gains is invested in subscription of shares of a company which qualifies to be an eligible start-up subject to other specified conditions. This investment amount must be further used by the start-up within one year from the date of subscription to equity shares, for purchase of 'new assets'. A 'new asset' is defined as new plant and machinery but does not include *inter alia*, computers or computer software. The Finance Bill, 2016 has proposed to amend the definition of new assets to include computers or computer software for technology driven start-ups. This exemption is applicable to only such transfer of a residential property made prior to March 31, 2019[6].

3. 100% deduction of profits for 3 consecutive years out of 5 years for Start-ups set up on or after April 01, 2016 but before April 1, 2019[7]. However, minimum alternate tax ("**MAT**") will apply to Start-ups, in such cases. Start-ups therefore could be scrutinised on their 'book profit' for the purposes of MAT, even when they have incurred net losses; and

4. Provide funding support to start-ups through a 'Fund of Funds' to be established by the Government[8]; The Government proposes to raise INR 25 Billion annually for 4 years to finance the start-ups.

Overall, the Government of India has allocated INR 11 Billion towards 'start-up and stand up' schemes[9].

The Action Plan had also proposed the following:

1. Self-certification for certain labour and environmental laws: Start-ups could be allowed to self-certify compliance though a mechanism determined by the Government of India with specific labour laws and environmental laws[10];

2. Scheme for Start-up Intellectual, Property Protection (SIPP) through Fast-tracking of Start-up patent applications, creating Panel of facilitators to assist in filing of IP applications, bearing facilitation cost, rebate on filing fees;

6. Clause 32 of the Finance Bill, 2016 and notes on clauses, provided thereof. It is proposed to amend section 54GB so as to provide that long term capital gains arising on account of transfer of a residential property shall not be charged to tax if such capital gains are invested in subscription of shares of a company which qualifies to be an eligible start-up subject to the condition that the individual or HUF holds more than fifty per cent shares of the company and such company utilises the amount invested in shares to purchase new asset before due date of filing of return by the investor.

7. Clause 41 of the Finance Bill, 2016 and notes on clauses, provided thereof.

8. Such funds of funds will invest in SEBI registered venture funds.

9. Annex No. III-B to Part A of the Budget Speech.

10. The Building and Other Constructions Workers' (Regulation of Employment & Conditions of Service) Act, 1996, The Inter-State Migrant Workmen (Regulation of Employment & Conditions of Service) Act, 1979, The Payment of Gratuity Act, 1972, The Contract Labour (Regulation and Abolition) Act, 1970, The Employees' Provident Funds and Miscellaneous Provisions Act, 1952, The Employees' State Insurance Act, 1948, The Water (Prevention & Control of Pollution) Act, 1974, The Water (Prevention & Control of Pollution) Cess (Amendment) Act, 2003, The Air (Prevention & Control of Pollution) Act, 1981.

3. Allowing better interaction and collaboration with the Government and other members of the Start-up ecosystem through creation of the 'Start-up Hub', envisaged by the Government of India.

4. Providing exemptions from criterion related to experience and/or turnover for public procurement contracts for Start-ups upon Start-ups showing requisite capability to execute the project as per the requirements of the Government, provided that the Start-up has their own manufacturing hub in India;

5. Providing credit guarantee fund for Start-ups.

However, there is no clarity thus far from the Government of India on the implementation of the above items provided in the Action Plan.

IndusLaw Quick View:

The Start-up India initiative by the Government of India is a welcome step. The initiative could promote development of innovation and the related programmes of the Government of India and enable companies to contribute to the overall 'start-up and stand up' initiative by providing innovative goods and services to growing Indian aspirations.

However, the definition of 'Start-up' is yet to be ironed for smooth operations. For instance one of the eligibility criterion states that an entity must have a 'letter of funding of not less than 20% in equity by any incubation fund / angel fund / private equity fund / accelerator / angel network duly registered with the Securities and Exchange Board of India'. This criterion seems onerous as 20% is a significant value of the entity and it could be difficult for investors (especially angels) to match the value. It could also seem to be restrictive to not include equity-linked instruments within the purview of this criterion, given the customary issuance of equity-linked instruments as opposed to ordinary equity in private equity financing. A clarification in this respect would be welcome.

If Start-ups are to be certified by the Government in order to obtain benefits under the schemes of the Government of India, more clarity is expected on the procedure, guiding principles and timelines within which the IMB must act.

Moreover, it is proposed that the 100% deduction of profits for 3 consecutive years out of 5 years shall be applicable only to those Start-ups set up on or after April 01, 2016 but before April 01, 2019. This could reduce the competitiveness of hitherto existing Start-ups and erodes the basic premise on which the Action Plan was envisioned. Further, it is also proposed that the capital gains from transfer of long term capital assets will not be taxed if the proceeds are invested into 'long term specified asset' issued by the Government of India prior to April 01, 2019. While much depends on the attractiveness of the 'long term specified asset', this could create a perverse incentive for investors to exit early from Start-ups in order to claim the tax benefit.

The Action Plan had also proposed exemption of 'Angel Tax' for start-ups, where the subscriptions to shares are above fair market value. But such exemption is not provided either in the Budget Speech or the Finance Bill, 2016.

An applicant must therefore make a careful assessment of the benefits at hand versus the costs and risks of engagement and data sharing with the authorities involved in Start-Up India.

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11. "Angel tax" refers to the tax on capital gains as provided in Section 56 of the Income Tax Act, 1961 that must be paid by unlisted companies as 'income from other sources' on any domestic investments received by an unlisted company against issuance of shares of the company above the fair market value.

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