Start Up Action Plan, 2016

I. Overview

Economies are ranked on their ease of doing business. A high ranking on the matrix of ease of doing business (as published in Doing Business Report[1]) means the regulatory and legal environment is more conducive to the starting and operation of a firm in the local economy. India was ranked 142nd in the Doing Business Report, 2015, and 130th in the Doing Business Report, 2016.

The Government of India ("**GoI**") has in the past year initiated several measures to improve India's ranking in relation to Ease of Doing Business. One such recent measure was the launch of the Start Up Action Plan, announced on January 16, 2016. The Action Plan proposes a 19-point action list including self certification, easier patent filing, tax exemptions, setting up a Rs.10,000 crore corpus fund, a faster exit mechanism, and credit guarantee, among others.

II. Detailed Aspects

This note highlights some of the key aspects of the Start up Action Plan.

(i) Definition of a Start Up

The definition of a Startup as provided in the Annexure to the Startup Action Plan is applicable only in case of government schemes.

For an entity to be eligible as a Startup it should be either a: (a) Private Limited Company[2]; (b) Registered Partnership Firm[3](c) Limited Liability Partnership[4] that has been incorporated/registered in India not prior to five years, with annual turnover not exceeding INR 25 crore (as defined in the Companies Act 2013) in any preceding financial year. The said entity should be engaged in innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.
Apart from the criteria that has been stated above, in order to be eligible as a Startup, the entity should:

[1] Doing Business Report is an annual World Bank Group flagship publication. The Doing Business project provides objective measures of business regulations and their enforcement across 189 economies and selected cities at the subnational and regional level. Several parameters such as ease of starting business, getting credit, payment of taxes, resolving insolvency, enforcing contracts, etc.
[2] Under The Companies Act, 2013.
[3] Under The Indian Partnership Act, 1932.
[4] Under the Limited Liability Partnership Act, 2008.

- be supported by 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
- be supported by an incubator which is funded (in relation to the project) from GoI as part of any specified scheme to promote innovation; or
- be supported by a recommendation (with regard to innovative nature of business), in a format specified by DIPP, from an Incubator recognized by GoI; or
- be funded by an Incubation Fund/Angel Fund/ Private Equity Fund/ Accelerator/Angel Network duly registered with SEBI* that endorses innovative nature of the business; or
- be funded by GoI as part of any specified scheme to promote innovation; or
- have a patent granted by the Indian Patent and Trademark Office in areas affiliated with the nature of business being promoted.

In order to be considered for tax benefits, the "Startup" entity will require an approval from the Inter-Ministerial Board proposed to be setup by DIPP to validate the innovative nature of the business for granting tax related benefits.

What shall not be a "Startup"?

- An entity will not be regarded as a Startup in the event such an entity is formed as a result of splitting up, or reconstruction, of a business already in existence.
- 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 shall not be considered as a Startup.
- An entity shall lose its status as a Startup in the event:
  a) if its turnover for the previous financial years has exceeded INR 25 crore; or
  b) it has completed 5 years from the date of incorporation/ registration.

From the above it is amply clear even though the Action Plan promises to simplify and streamline the regulatory requirements, an entity in order to qualify as a "Startup", and avail any benefit under a government scheme is required to fulfill numerous and varied requirements.

Additionally, in the event a Startup desires to avail of any tax related exemption, it would need to get approval from the Inter-Ministerial Board proposed to be setup by DIPP to validate the innovative nature of the business for granting tax related benefits.

This essentially means that a Startup would once again be subject to a regulatory approval, which the Action Plan had set out to minimize. Tax benefits and reliefs should be a time bound process, and not subject to discretionary regulatory approvals of an Inter-Ministerial Board.

The definition also clearly provides that for entities to qualify as a Startup should be engaged in innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property. Therefore, this would exclude a number of Startups which may be engaged in providing a value add product or service to the consumer but may not be necessarily driven by technology or intellectual property. This would limit the applicability of the Action Plan gravely.

There is also no objective criteria that has been laid down to determine whether a particular business has "significantly improved existing product or service" or that it actually ", or will create or add value for customers or workflow".

Finally, there seems to be inconsistency in the annual turnover requirement. In the main definition (Part A of the Annexure) it has been stated that an entity should not have an annual turnover less than Rs 25 crore in <u>any financial year</u>. In contrast, the second proviso to the definition provides that an entity would cease to be a Startup if its turnover for the <u>previous financial years</u> has exceeded INR 25 crore. This ambiguity should be clarified.

(ii) Self-Certification:

Undue delays and high costs associated with regulatory compliance often hamper the development of a startup business in an economy.

Labour Laws

- 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; and
- The Employees' State Insurance Act, 1948

Environment Laws

- 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

The Startup Action Plan has introduced 'Self Certification' in relation to certain specified labour and environmental laws, which will reduce the regulatory burden.

Under the Action Plan, a Start Up Business is allowed to show proof of compliance in relation to the specified labour and environment laws by self-certification.

In case of labour law, no inspection would be conducted for three years. An inspection would be conducted on receipt of credible and verifiable complaint of violation, filed in writing.

In case of environmental laws, the start ups which fall within the 'white category' as defined by the Central Pollution Control Board, would be allowed to self certify. In such cases, random inspections would be carried out.

(iii) Tax Relief

The following tax exemption and/or tax relief schemes have been proposed as a part of the Action Pan:

a) *Capital Gain Exemption:*

- Investment made by individuals in Startups would be provided capital gains exemption. In order to avail the benefit of the capital gain exemption, such capital gains in the Startup corpus fund created by the Government under the said Action Plan.
- Existing capital gain tax exemption for investment in newly formed manufacturing MSMEs by individuals would be extended to all Startups.
- Investment in 'computer or computer software' (as used in core business activity) would also be considered as purchase of 'new assets' and therefore subject to the capital gain exemption.

b) *Income tax exemption*:

Startups would be provided an income tax exemption for a period of 3 years. The exemption is subject to non-distribution of dividend by the Startup. From the above, it is not very clear whether the three-year time period is to be calculated from the time period that the Startups start earning "profits" or will apply to them for a period of three years from the date of incorporation. In fact, a Startup would not really be making any profits during its initial years of operation and so the exemption would hardly bestow benefits as it claims on Startups.

c) *Income tax exemption on consideration received above Fair Markey Value*:

Any consideration received by Startups for issuance of shares over FMV to incubators, not to be taxed in the hands of the Startup[5]. The term 'incubator' needs to be defined. Further, investments in startups made by venture capitalists, angles funds, and HNIs should also be considered for the purpose of the said exemption.

In addition, it is quite surprising that the Action Plan makes no mention of any indirect tax relief. Indirect tax liability would be a substantial liability for any business and any exemption from the same would provide a huge impetus to the Startup businesses.

The Action Plan provides a framework policy and most of these issues should hopefully get clarified under upcoming Union Budget.

(iv) Startup Intellectual Property Protection

The Action Plan provides the following measures for Startup Intellectual Property Protection ("**SIPP**"), which would be implemented on a pilot basis for a period of one year initially:

a. Fast-tracking of Startup patent applications: System devised to fast track patent examination and disposal;
b. Panel of facilitators to assist in filing of IP applications: A panel of facilitators would be empanelled by the Controller General of Patents, Designs and Trademarks (CGPDTM), which will provide general advice on - different IPRs, information on protecting and promoting IPRs in other countries, provide assistance in filing and disposal of the IP applications, appearing on behalf of Startups at hearings and contesting opposition, if any, by other parties, till final disposal of the IPR application.
c. Central Government to bear facilitators costs: The Central Government would bear the costs/fees of the facilitators for any number of patents, trademarks or designs that a Startup may file. The Startup would be required to pay the statutory fees.
d. Rebate on filing of patent application: As a part of the scheme, the Startups

[5] Under the present legal regime provided under the Income Tax Act, 1961, in the event a company receives any consideration for issue of shares which exceeds the Fair Market Value (FMV) of such shares, such excess consideration is taxable in the hands of recipient as Income from Other Sources

would be provided 80% rebate in filing of patents in relation to other companies.

(v) Participation in Public Tenders

In order to facilitate a Startup to participate in a tender, the Government would exempt Startups (in the manufacturing sector) from the criteria of "prior experience/ turnover" without any relaxation in quality standards or technical parameters.

The Startups will have to demonstrate requisite capability to execute the project as per the requirements of the tenders. Further, the Startups should have their own manufacturing facility in India.

However, it is not very clear that why only the Startups in the manufacturing sector have been provided the stated relaxation.

(vi) Mobile Hub

It has been proposed that a Mobile App and Portal would be launched by April 1, 2016, which would enable a number of activities including:

- registration of Startups;
- filing of compliances;
- obtaining information on various clearances/ approvals/ registrations; and
- applying for various schemes of the Government.

(vii) Exit Mechanism

The Action Plan highlights that The Insolvency and Bankruptcy Bill 2015 ("IBB"), will enable faster exit for Startups, as the Startups that satisfy the prerequisites of the IBB will be allowed to be wound up in 90 days on a fast track basis.
However, the IBB has been a long pending Bill and therefore, the actual impact of the provisions of the said proposed legislations can be gauged only once it is passed and notified.

Till the IBB is passed, the Government should provide some transition/interim scheme that will permit a Startup to windup in a time bound and cost effective manner.

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(viii) Creation of a Core Startup Fund

In order to facilitate and provide easy access to funding to Startups, a total corpus of INR 10,000 crore over a period 4 years (i.e. INR 2,500 crore per year) would be set up by the Government. This mega fund would not make any direct investments in the Startups. The fund would be provided in the form of SEBI registered Venture Funds and would:

- be managed by a Board with private professionals drawn from industry bodies, academia, and successful Startups;
- have the Life Insurance Corporation (LIC) as a co-investor;
- contribute to a maximum of 50% sub fund wherein the sub fund should have already raised the balance 50% or more of the stated fund size as the case maybe;
- have representation on the governance structure/ board of the venture fund based on the contribution made; and
- ensure support to a broad mix of sectors such as manufacturing, agriculture, health, education, etc.

(ix) Credit Guarantee

In order to facilitate debt financing to Startups, a credit guarantee scheme is envisaged under the Action Plan, which will have a corpus fund of INR 500 crore per year for the next four years.

(x) Capacity Building

- **Launch of Atal Innovation Mission ("AIM")**

AIM proposes to promote entrepreneurship through Self- Employment and Talent Utilization ("SETU"), which will include establishment of sector specific incubators; Strengthening of existing incubation facilities; and Seed funding to high growth startups, among other things

- **Setting up of Incubators**

35 new incubators to be set up in existing institutions.

- **Research Parks**

7 new research parks are proposed to be set up with an initial investment of Rs.100 crore each. These parks would enable companies with a research focus to set up base and leverage the expertise of academic/ research institutions.

- **Promote entrepreneurship in biotechnology**

5 new bio clusters, 50 new bio incubators, 150 technology transfer offices and 20 bio connect offices will be established though Biotechnology Research Assistance Council (BIRAC).

Biotech Equity Fund – would be set up in partnership with National and Global Equity Funds to provide financial assistance to young Biotech Startups.

The Action Plan proposes a number of schemes to “galvanize the Startup ecosystem and to provide national and international visibility to the Startup ecosystem in India. Some of the schemes are as follows:

III. Looking ahead

The Action Plan does look into the critical issues which affect a business (especially a Startup Business), however, the real impact of the plan may only be tested once the relevant policies, and notifications are announced for the implementation of the same. The Action Plan appears a tad short on practical issues of implementation, and real benefit. As an example, the income tax exemption contemplated by the Action Plan may not have a real impact as most of the start ups would not be making profits during the first few years of their operations. It may therefore, be instructive to implement the Action Plan via legal instruments only after receiving views from the relevant stake holders. Having noted this, the regulatory relaxations from scrutiny and administrative action perspective is a welcome step in the right direction.