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STARTUP INDIA ACTION GOVERNMENT PLAN 2016 AND RELATED ANNOUNCEMENTS: LET'S STARTUP!

The Government of India, through the Department of Industrial Policy and Promotion ("**DIPP**"), Ministry of Commerce and Industry, has issued an 'Action Government Plan 2016' (the "**Government Plan**") on January 16, 2016, to ease the regulatory framework and provide wider funding avenues to startups.

The Government Plan has been introduced in keeping with the current Government's vision to create wealth, employment and self-empowerment among young Indian entrepreneurs. The Government Plan is aimed at providing young Indian entrepreneurs a launch-pad to explore and pursue their business ideas in India. As the Government Plan is mostly focused on startups in the initial phase, it is important and remains so continually, for the Government to provide an effective implementation mechanism in line with the main objectives of the Government Plan; else, it will remain a mere paper tiger. The manner in which some of these operational aspects will be implemented, in order to make the workings of the Government Plan effective, in fact and in reality, on the ground, needs to be examined in the coming days.

A major follow-up in terms of seeking effective implementation of the Government Plan has come from the Reserve Bank of India (the "**RBI**") by way of the RBI Governor, Dr. Raghuram G. Rajan's sixth bi-monthly monetary policy statement, on February 2, 2016. In that Statement, the RBI has indicated it will take steps to ease doing business and will contribute to the startup ecosystem. Towards that end, the RBI has issued on the same day a press release on its proposed 'regulatory relaxations for startups' (the "**Press Release**") seeking to ensure ease of business and simplified regulatory compliances; both the Government Plan and the Press Release are discussed in this Update.

While the actual amendments to various legislations and the RBI regulations are awaited, the Government Plan and the Press Release provide positive expectations on the upcoming reforms, which were long overdue.

1. <u>WHAT IS A "STARTUP"?</u>

For the purposes of availing government schemes, any private limited company or a registered partnership firm in India:

- incorporated or registered in India less than 5 years ago;
- having an annual turnover not exceeding INR 25 Crore (or INR 250 Million) in any preceding financial year; and
- working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property,

will be treated as a startup ("**Startup**").

Any entity that meets the above criteria due to demerger or reconstruction of a business already in existence, will not be considered as a Startup. Further, the Government Plan clearly indicates that existing startups would not able to convert or restructure themselves to fit the requirements of, and take advantage of benefits provided in, the Government Plan, and the only possible options available with them to take advantage of the scheme is to either novate their existing business model or introduce an entirely new business plan, different from their current business.

In case a Startup's turnover exceeds INR 25 Crore (or INR 250 Million) during the previous financial year, or if it completes 5 years from incorporation / registration, it will cease to be treated as a Startup for the purposes of the Government Plan and will no longer be entitled to those benefits.

In order for a Startup to be considered eligible, it should be:

(a). supported by a recommendation with regard to the innovative nature of its business, in a format specified by DIPP, from an incubator established in a post-graduate college in India providing such facility; or (b). supported by an incubator which is funded (in relation to the project) from the Government as part of any specified scheme to promote innovation; or

(c). supported by a recommendation with regard to the innovative nature of its business, in a format specified by DIPP, from an incubator recognized by the Government (the Government Plan is currently silent on the process for incubators to get so recognized); or

(d). funded by an incubation fund / angel fund / private equity fund / accelerator / angel network duly registered with the Securities and Exchange Board of India ("**SEBI**") that endorses innovative nature of business; or

(e). funded by the Government as part of any specified scheme to promote innovation (the Government Plan does not, at the moment list, any such government scheme for purposes of information or for checking their eligibility by the concerned startups); or

(f). has a patent granted by the Indian Patent and Trademark Office in areas affiliated with the nature of business being promoted.

The Government Plan has not specifically identified post-graduate colleges presently, and has also not provided any guidelines on how an entrepreneur may approach such post-graduate colleges providing incubator facilities for startups. The Government Plan also does not presently provide for any parameters to evaluate the 'innovative nature of business' and that appears to be mostly dependent on the commercial viability of the product or services offered along with differentiated features from existing similar products or services.

It may be argued that the definition of a 'Startup' and the eligibility criteria, are far from ideal. For example, several VC / PE funds investing in India are not required to, and therefore are not, registered with SEBI (whether as an 'Alternative Investment Fund' or otherwise). It would appear, at first glance, that such startups funded by such non-registered entities are not covered under this definition. Also, as is evident, many aspects of the eligibility criteria are still dependent on the Government issuing further clarifications and operational or implementation rules, so as to make the Government Plan effective in practice.

2. HIGHLIGHTS OF THE GOVERNMENT PLAN

Some of the significant features, or benefits, of the Government Plan are as follows:

(a). ***Self-certification based Compliance Regime*:** The Government Plan allows Startups to self-certify compliance under specified labour and environmental laws. This includes compliance with certain critical labour laws – such as, relating to provident funds; employees' state insurance; contract labour; and gratuity.

From a labour law perspective, this is a significant step to loosen, tending to the removal of, the 'inspector raj' – as inspections by the labour department to verify compliance would be limited to instances of credible and verifiable complaints for an initial period of 3 years (from the date of the incorporation of the concerned Startup). Similarly, Startups that fall within the "white category" as defined by the Central Pollution Control Board, having least environmental impact on air, land and water in terms of their operations, would be allowed to self-certify for applicable compliances. Startups would however do well not to treat this relaxation as a free pass or ride; since rigorous compliance post the specified 3-year period after the incorporation of the concerned Startup, would continue to be expected. Further, prospective investors do undertake due diligence reviews prior to investing, and a good compliance record creates a good impression, and minimizes future liabilities

(b). ***Funding Facilities*:** The Government will set up a fund that will act as a "fund of funds" and, along with the Life Insurance Corporation, invest in SEBI-registered venture funds. A board will manage this fund with professionals from industry bodies, academia and successful startups. Its initial corpus would be INR 2,500 Crore (or INR 25 Billion) with a total corpus of INR 10,000 crore (or INR 100 Billion) over a period of 4 years (i.e., INR 2,500 Crore, or 25 Billion, for each of those 4 years).

This fund will contribute only up to 50% of the venture fund's size, and the said venture fund must have raised the balance 50% or more of the stated fund size, through other sources. Additionally, to enable debt assistance for Startups, credit guarantee mechanism through the National Credit Guarantee Trust Company or the Small Industries Development bank of India has also been envisaged, with a budgetary corpus of INR 500 Crore (or INR 5 Billion) per year for the next 4 years.

This funding aspect is one of the most notable features of the Government Plan. The implementation and operationalization of this fund would be of the highest concern to the subscribers of this fund, as the subscribers have to raise the initial 50% of their expected fund size. Additionally, it is to be seen whether Government would be able to successfully raise the corpus of the proposed "fund of funds".

(c). ***Relaxed Taxation Regime*:** Profits earned by Startups will be exempted from income-tax for an initial period of 3 years, subject to non-distribution of dividend by the said Startup. It is unclear currently whether this scheme would apply going forward, for 3 years calculated from the date of such Startup's incorporation, or for the next 3 years independent of the date of incorporation of the Startup.

As the Government Plan is mostly focused on the initial development of Startups, it can be assumed that the exemption would be applicable from the date of incorporation of the concerned Startup, subject to any clarification issued by the income tax authorities. Although in the absence of clarity on the implementation of this aspect currently, the viability of the Government Plan is significantly impacted as no one can take a conclusive view in this regard. Also, Startups may not turn profitable at all in the first 3 years of their existence in order to take advantage of this exemption, with many informed observers therefore suggesting that the Government would do well to clarify that this 3 year period is to be calculated from the financial year in which profits are first registered, but within say a 5 or a 7 year period post incorporation.

Investors will be provided with exemption on capital gains during the financial year, if such capital gains are invested in a "fund of funds", recognized by Government for funding Startups. So, while the Government Plan has advantages to Startups, it also provides many new features and facilities to the investors in, or who fund, such Startups – leaving it vulnerable to the charge that the Government Plan is effectively a sop to investors. That said, the pro-entrepreneur points of the scheme are laudable as a statement of intent at the very least, where, in order to become an effective initiative, much remains to be done as to how these aspects will be operationalized.

Also, existing capital gains tax exemption that has already been provided to newly formed manufacturing MSMEs, will be extended to all Startups. Under this scheme currently, purchase of new assets is mandatory to availing the exemption. With a view to promote technology-driven Startups, investment in computer or computer software (as used in core business activity) will be considered as purchase of "new assets".

Additionally, the Startup will receive tax exemption on the investment amounts received in excess of fair market value from incubators. Such an exemption was previously recognized only for investments made by a venture capital fund, which also acts as one of the exit benefits for Startups.

Critically, tax benefits will be extended only upon certification from the Inter-Ministerial Board that would be set up by the DIPP for this purpose, which indicates that Government will provide any exemption only after proper evaluation of the Startup. Further, it indicates that the Government will have a close check on the operations of the Startups – it is perhaps true that while the dreaded 'inspector raj' may not resurface, the complete absence of Government in the entrepreneurial world is unlikely to happen, in particular, as regards a relaxed taxation regime, as ultimately the Government would wish genuine developmental benefits to flow through and with Startups and not simply the taking advantage, solely for tax planning and taxation reduction benefits, of a liberal taxation regime.

(d). ***App Based Connectivity*:** The Government Plan recognizes the absence of a comprehensive platform to enable Startups to register and comply with various laws. To this extent, the Government proposes to set up a mobile app to help Startups register (as a company or partnership firm), monitor the progress of its registration, make filings from time to time on various compliances and approvals, as well as access funding and other government schemes (discussed in this Update). This app is proposed to be made available from April 1, 2016. Additionally, Ministry of Corporate Affairs, Government has issued the Companies (Incorporation) Amendment Rules, 2016 and has established a Central Registration Centre, New Delhi, to simplify the process of incorporation of the Startups and reservation of names under the Companies Act, 2013.

(e). ***Fast-track Patent Examinations, and Assistance in IP Applications*:** Patent applications will be fast-tracked for examination and disposal. The relevant regulator who will play a general advisory role will empanel facilitators to assist Startups. However, the Government Plan does not provide the process of empanelment of these facilitators, which is another area where implementation of the Government Plan becomes difficult.

It is intended that these facilitators will help Startups access all the information they need, including identifying the right protections that are required, as well as help make necessary filings. These facilitators shall also assist in the filing, and in the representation up to the stage of disposal, of an intellectual property application (including appearing on behalf of Startups at hearings and contesting oppositions). The Government will bear the fees payable to such facilitators so that the Startup will only need to pay the nominal statutory fees. As the Government Plan does not currently provide for any manner of payment of costs incurred by such facilitators, or the timeline within which such facilitators would be paid, these aspects are an area of concern for such facilitators assisting in the process of various intellectual property registrations and related filings.

Additionally, Startups will be provided an 80% rebate in filing of the patent applications. This scheme however is currently envisaged to be launched on a pilot basis for the first year of the introduction of the Government Plan.

(f). ***Faster Exit Norms*****:** The Insolvency and Bankruptcy Bill 2015 ("**Bill**"), currently under consideration by the parliament, provides norms for fast track and / or voluntary closure of businesses. Startups that have simple debt structures or those meeting the criteria prescribed (which are yet to be prescribed and notified for the purposes of the Bill), will have the ability to wind-up the entity on a fast track basis, within 90 days of application. An insolvency professional would be appointed to liquidate the assets and pay the creditors within 6 months. While the Government Plan hints at simplifying the process, the manner of its implementation especially with both the liquidator and insolvency professional being in-charge of the liquidation, needs to be examined closely once the Bill is implemented as the law of the land.

In addition to the above, the Government Plan also seeks to extend support to Startups generally, and has provided other incentives such as the relaxation of eligibility norms to enable participation of Startups in public procurements, the setting-up of national and international platforms to help Startups connect with relevant stakeholders annually, and the establishment of innovation and incubation centres across the country to provide mentorship to various Startups.

3. HIGHLIGHTS OF THE PRESS RELEASE

Following the issuance of the Government Plan, the RBI with the intention to assist the current startup ecosystem, has proposed certain relaxations in the Press Release, which are under discussion presently with the Government and key highlights of the same are as follows:

(a). Startups, irrespective of the sector of their operation, will be enabled to receive foreign venture capital investments and, explicitly, to permit the transfer of its shares from any such foreign venture capital investor to other residents or non-residents.

(b). In case of the transfer of ownership of a startup, the consideration amount can be received on a deferred basis enabling escrow arrangements or indemnity arrangements for a maximum period of 18 months.

(c). Online submission of reporting forms depending on the nature of the transactions, and simplified penalty structures for delayed Foreign Direct Investment ("**FDI**") compliances.

(d). Amendments to External Commercial Borrowing or ECB regime to enable Startups to avail rupee loans from eligible lenders.

(e). Startups can issue FDI instruments like convertible notes, and also issue shares without cash payment through sweat equity or against any legitimate payment owed by the company, remittance of which does not require any permission under FEMA.

Additionally, RBI has created a dedicated e-mailbox to provide assistance and guidance to startups. Further, electronic reporting of investment and subsequent transactions will be made on the e-Biz platform only. While the notification regarding mandatory submission of forms online through e-Biz platform has already been implemented and will be implemented from February 8, 2016, all other proposals are under consideration and relevant circulars, notifications and rules are yet to be notified. It is again evident from these proposals that many of them will have a significant positive impact on the ease with which startups are able raise capital, whether from financial investors or through debt; and, to that extent, both the Government Plan and the RBI's initiatives may well have their intended positive effect on the galvanization of the startup ecosystem and the funding of such ventures.

4. CONCLUSION

The Government Plan and the Press Release are welcome steps for promoting entrepreneurship and boosting innovation in India. It is important to note that both are, however, currently policy announcements only. New legislations / amendments to existing legislations, as well as implementing rules and regulations, will need to be made in the coming days to operationalize and implement these policies and schemes. Similarly, relevant notification or amendments must be made by RBI to the existing foreign exchange regulations.

While the Government Plan seeks to ease the hurdles faced by Startups, the benefits will be extended only to such Startups who are certified (and, especially as regards tax exemptions, by the relevant Inter-Ministerial Board to be set up by DIPP). This certification process should not, counterproductively, end-up becoming the very bottleneck that is being sought to be removed. It is pertinent to note that, apart from regulations to operationalize the Government Plan, it is unclear about the manner of implementation in many ways, which could be a hurdle to easing the norms. Also, while the Government Plan does provide for certain benefits such as self-certification and tax exemptions but to avail such exemptions, one must require governmental approvals. So, most Startups would be prudent in assuming that while the Government Plan does seek to dismantle most of the requirements for clearances, it does not provide for a completely unregulated environment for startups, especially where exemptions are sought to be availed.

Similarly while the RBI has announced relaxation of various regulations, the extent to which such relaxation actually harmonises the anomaly that currently exists in the treatment of non-resident, *versus* non-resident Indian *versus* Person of Indian origin investments, and venture capital funds *versus* foreign venture capital investors *versus* alternative investment funds investments, across sectors, needs to be seen.

We are happy to further discuss these developments, including how they impact your organization further. We are reachable at the contact details provided below.

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