Startup Ecosystem in India

Tax Incentives and Funding Opportunities for Startups

DRBM Corporate Consulting Private Limited

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This paper is intended to highlight the Development of Startup Ecosystem in the country along with Tax Incentives and Funding Opportunities available to Startup under various schemes of the Government.

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Introduction

India the leading economy in the world, currently positioned itself at 3rd place, has been the fastest growing base for Startups worldwide. By virtue of the efforts taken by the Government of India and Hon. Prime Minister Narendra Modi, Project Startup India has been initiated to build a strong eco- system for nurturing innovation that will drive sustainable economic growth and generate large scale employment opportunities. The aim is to empower Startups to grow through innovation and design. The objective of this paper is to throw light on the initiative schemes taken by the Government of India for Startups along with the tax incentives and funding opportunities for Startups.

As per the Notification of DIPP dated February 17, 2016, an entity shall be recognised as a Startup up to a period of five years from the date of incorporation / registration, if its annual turnover does not exceeding INR 25 Crores in any financial year and it is working towards the innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property. It has been further explained that entity would mean a Private Limited Company or a Registered Partnership Firm or a Limited Liability Partnership.

Startup Ecosystem in India

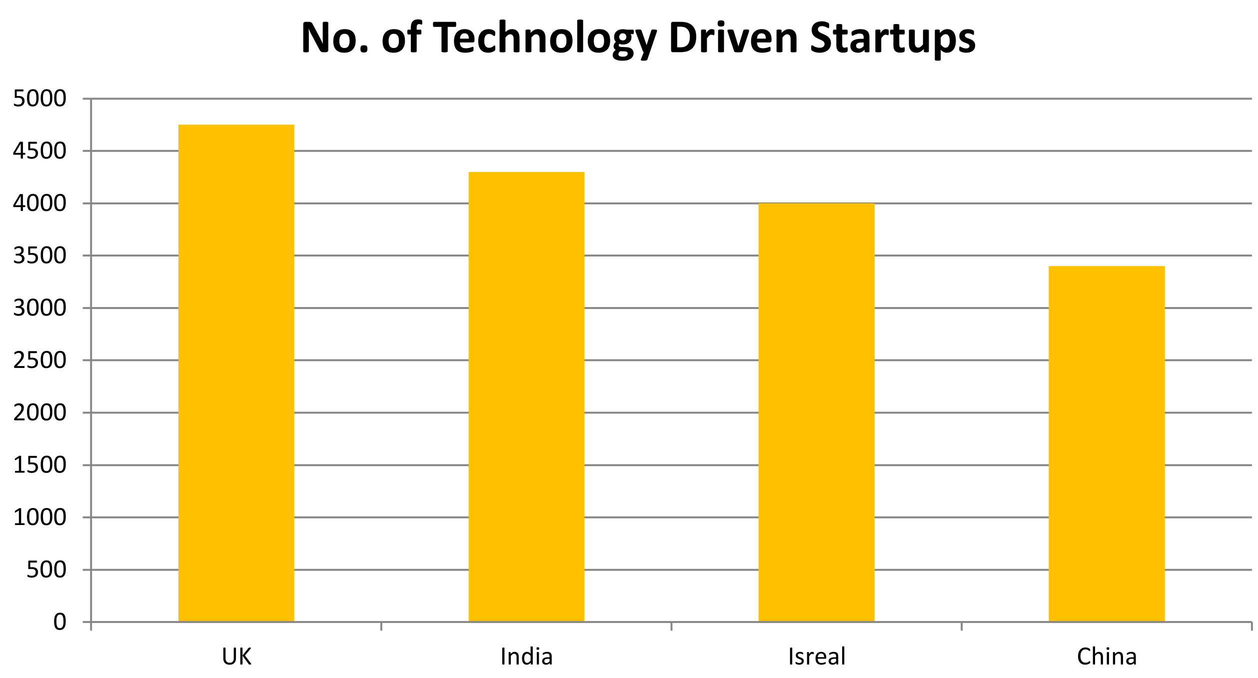
India has been a lucrative country for investment due to various reasons; inter-alia India has young and aspiring minds with the average age being 28 years of the Startup founders. Mr. R Chandrashekhar, Chairman of NASSCOM once quoted "In addition to employing 100,000 people and enhancing the lifestyle of citizens, Startups are creating innovative technology solutions that address key problems that India as a country face-around education, healthcare, financial inclusion, energy / utilities etc."

The major startup cities are Bengaluru, Delhi NCR, Mumbai (Tier 1), followed by Chennai, Pune, Hyderabad (Tier 2), Kolkata, Kochi, Jaipur, Chandigarh, Indore (Tier 3) etc. In India less than 10% of the population lives in tier 1 cities and also there exists income disparity within the population.

As per the current market analysis, Indian Startup base is expected to witness a YoY growth of 10-12%. Government is taking up aggressive in Startup agenda policies. The focus would be to provide Startups with adequate resources and knowhow to establish profitable, scalable and sustainable businesses.

The number of incubators and accelerators has also witnessed a 40% YoY growth in 2016, with 35 new additions under the Startup India initiative. The technology driven incubators and accelerators do not limit its focus to specific industries. But as every coin as two sides, there are opportunities and hurdles faced, the eco system is itself trying to mitigate. The Central Government is proactive with aggressive growth plans in this regard.

As per one of the Study Reports of NASSCOM, the number of Technology Driven Startups at the end of 2015 in USA was in the range of 47k to 48k. The same ranges between 4.5k to 5k in UK and 4.2k to 4.5k in India. Israel and China are also showing good development of Startup Ecosystem.



Tax Incentives and Exemptions

To support the Startup India Action Plan, Finance Act, 2016 proposed exemption to Startup Companies from payment of Income Tax for a period 3 consecutive years in a block of 5 years, if the companies are incorporated after 01 April 2016 but before 31 March 2019. It is a well-accepted fact that Startup Companies usually take substantial period of time to achieve breakeven and to turn into a profitable venture. Considering this fact, it was suggested that the period of block of 5 years may be extended to 7 years in Union Budget 2017-18. As such, a Startup can claim tax exemption for any 3 consecutive years in a block of 7 years.

This Tax Exemption is covered under Section 80-IAC of the Income-tax Act, 1961 in the form of 100% deduction from profits & gains derived from eligible business.

Section 54EE is the new section in the series of Capital Gains Exemption sections. In order to assist Startup Companies raise fund, Finance Act, 2016 introduced various Startup Funds and to finance these Startup Funds, section 54EE was introduced which provides for exemption of Capital Gains if the proceeds of transfer of Long Term Capital Asset are invested in a fund notified by the Central Government. The limit for such exemption is INR 50 Lakhs.

With effect from 01 April 2017, Section 54GB of the Income-tax Act, 1961 was amended to include benefits for Startup Companies. Prior to 01 April 2017, An Individual / HUF could sell the Residential Capital Asset to start a business. The Sale Proceeds were required to be invested to subscribe equity share capital in a private limited company and then the company was required to use the money to acquire new Plant & Machinery. Similar provisions have now been extended to Startup Companies.

Section 56(2)(viib) of the Income-tax Act, 1961 levies tax on Share Premium. That is to say if a closely held company receives consideration for issue of shares which exceeds the Face Value of the Shares, then the consideration as exceeds the Fair Market Value of the shares shall be taxable in the hands of such a company. First proviso to this section exempts companies or class of companies as notified by the Central Government from the applicability of this section. Accordingly, by the power conferred by clause (ii) of the proviso to section 56(2)(viib) of the Income-tax Act, 1961, Central Government issued Notification dated 14 June 2016 to exempt Startup Companies as recognised by DIPP of the Ministry of Commerce & Industry. As such, consideration received by Startup Companies in excess of Fair Market Value shall not be taxable in the hands of such Startup Companies. This has made fundraising for Startup Companies even easier.

The Devil is in the Details. A startup willing to claim tax incetives has to obtain Certificate of Eligibility from the Inter-ministerial Board of the Department of Industrial Promotion & Planning (DIPP), Ministry of Commerce & Industry of the Government of India. Further, there is a catch on the Annual Sales Turnover which should not exceed INR 25 Crores in any financial year up to 31 March 2021. Speaking about tax rate, Minimum Alternate Tax (MAT) is still applicable for Startup Companies @ 18.5%. This is a Blessing in Disguise. Such companies shall be able to claim MAT Credit as per the provisions of section 115JA and 115JB of the Income-tax Act, 1961 once they start paying normal taxes.

Funding Opportunities

Startup Companies often face problems raising funds for their projects. May it be lack of past experience, may it be non-availability of Collateral Security, may it be any other reason; fundraising for Startup Companies has always been a pain in neck. Startup India Scheme has tried to solve this problem to a great extent.

As explained earlier, Capital Gains Exemption under section 54EE has prompted fundraising for government notified funds. These funds in turn have to finance eligible startup projects.

Union Budget 2016-17 introduced a **Fund of Fund for Startups** with a corpus of INR 10,000 Crores under the monitoring of SIDBI. FFS was to invest in SEBI registered Alternate Investment Funds and these AIFs in turn have to make funds available to Startup Companies. As per the Status Report dated 15 May 2017, more than INR 600 Crores have been released. Total commitments to 17 AIFs stand at INR 623.50 Crores. Around 62 Startup Companies have received funds till date from different AIFs. Given below is the list of recognised AIFs:

Sr. No.	Name of the AIF	Commitment (INR in Crores)	No. of Startups funded
1	Kae Capital Fund II	45.00	16
2	Orios Venture Partners Fund II	40.00	5
3	Saha Fund Scheme I	10.00	10
4	Kitven Fund III	5.00	-
5	Unicorn India Ventures Fund I	4.00	9
6	Idea Spring Capital – Future Now	18.00	2
7	Oorja Capital	58.50	-
8	Pi Ventures Fund I	40.00	4
9	Chiratae Trust	90.00	9
10	Ventureast Proactive Fund II	30.00	-
11	Omnivore Partners India Fund 2	75.00	-
12	Parampara Early Stage Opportunities Fund I	15.00	3
13	Ivycap Ventures Trust Fund II	30.00	3
14	IAN Fund I	50.00	-
15	Aavishkar Bharat Fund	35.00	-
16	Stakeboat Capital Fund I	50.00	-
17	Stellaris Venture Partners Fund I	28.00	1
	Total	623.50	62

A concept called SAFE (Simple Agreement for Future Equity) was introduced around 2012 by **Y Combinator** which is a US based Incubator. SAFE allows startups to raise funds from investors which do not take form of either debt or equity. SAFE is similar to the Convertible Notes. However, in the Indian context, issuing convertible notes to foreign investors was always forbidden since the Reserve Bank of India and the Ministry of Commerce and Industry allowed foreign direct investment only in equity instruments or such other instruments that were considered at par with equity like compulsorily convertible preference shares or compulsorily convertible debentures. With effect from 10 January 2017, RBI has amended the Foreign Exchange (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000, to allow Startup Companies to issue Convertible Notes to foreign investors. This has opened a plethora of funding opportunities for Startup Companies; also allowing the investor to grab early bird benefits.

A Convertible Note is an instrument issued by a Startup Company evidencing receipt of money initially as debt, which is repayable at the option of the holder, or which is convertible into such number of equity shares of such Startup Company, within a period not exceeding five years from the date of issue upon occurrence of specified events as per the other terms and conditions agreed to and indicated in the agreement.

Convertible notes are initially recognised as a Debt Instrument. As the name indicates, CNs are convertible into equity shares of the Company after a predetermined period or after a predetermined condition of an event like Series A funding / Institutional Investment etc. CN Investors often get discount over the Valuation as determined by Series A Investor or Institutional Investor and accordingly CN holder end up getting more equity shares of more value of the same equity shares. Surpassing the barriers of Valuation, Pricing and Discount etc., Convertible Notes are proving to be a great instrument for Startup Companies for raising funds. Please read DRBM's publication on the Convertible Notes for more information.

Apart from traditional funding sources like Banks, AIFs etc., **Crowd-funding** has become one of the most appreciated ways of raising funds. India currently does not have a legal framework for Crowd-funding. A concept paper on Crowd-funding issued by the Securities & Exchange Board of India proposed several alluring amendments to the existing framework; however, the chaos caused due to warnings issued by SEBI in September 2016 insisted many Crowd-funding Platforms in the country keep their operations on hold. However, following Private Placement Guidelines as per the provisions of the Companies Act, 2013 and related provisions of Foreign Exchange Management Act, Startup Companies can raise funds from Foreign Investors without attracting complications of SEBI.

Following the Private Placement regulations, Indian Startup Companies can raise funds from Foreign Investors and there is no bar on any amounts except as specified in FDI / ECB Guidelines. Funds can either be raised as Foreign Direct Investment or as External Commercial Borrowings. Depending upon the type of the product, the nature of the investment i.e. FDI / ECB would change and accordingly, procedural requirements would change.

Please read our Write up on India Crowd-funding for more information.

Closing Remarks

We trust that this paper throws light on the array of business opportunities and tax benefits available for the Startups in India. The Government aims at creating job and growth opportunities for young and educated India and also provide environment for creative young minds to nurture their ideas and innovation. Entrepreneurs whether young or old, should definitely take benefit of these Government Initiatives.

About DRBM

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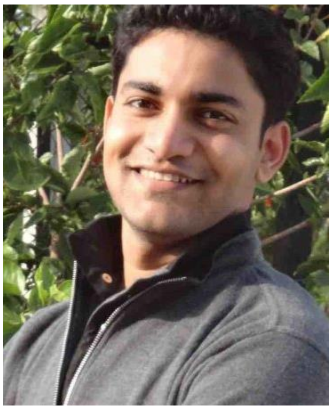

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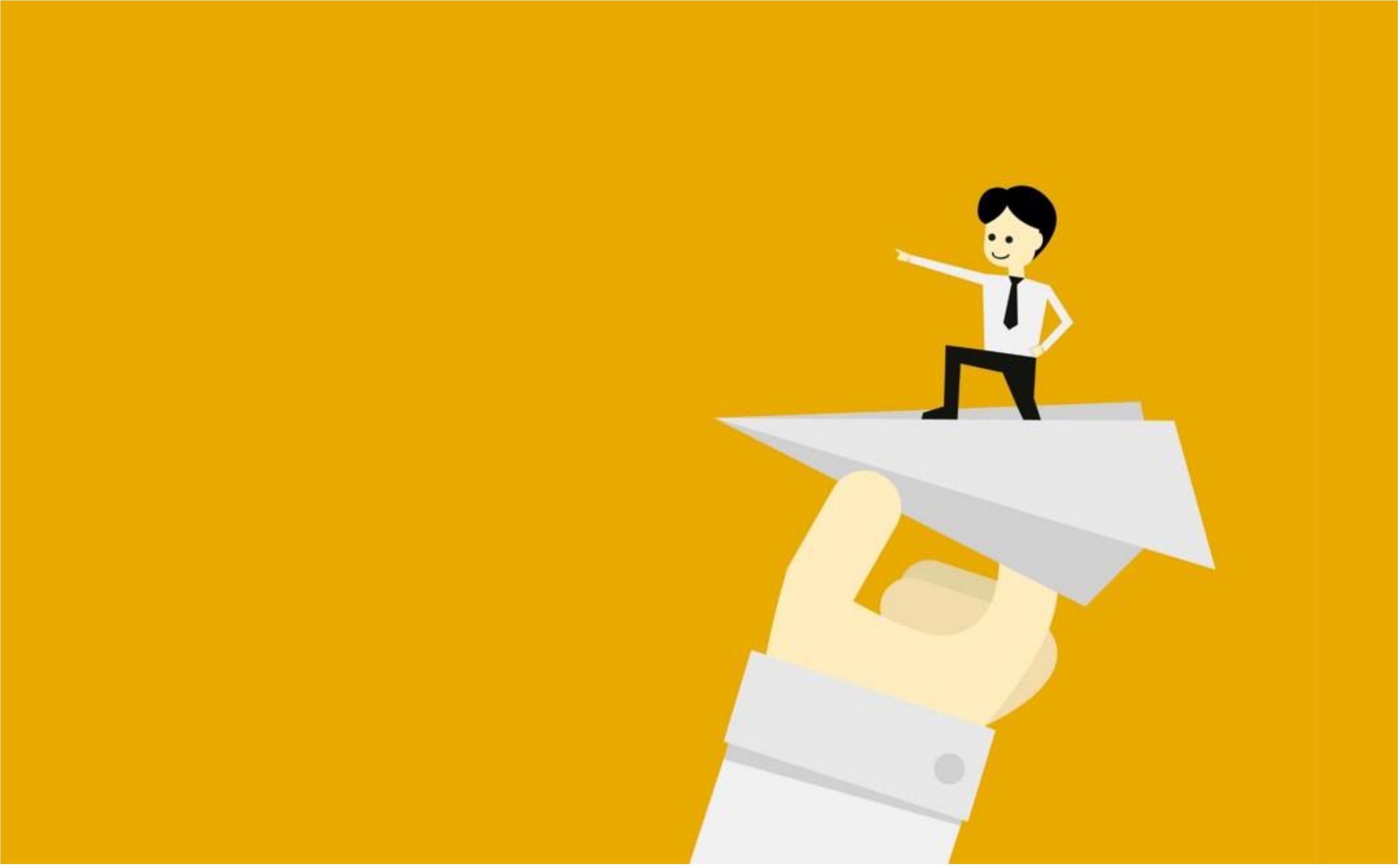

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Credits: Status Report on Startup India Scheme, Startup India Action Plan and NASSCOM Study Report