Regulatory Hotline

February 24, 2016

FLURRY OF REFORMS FOR STARTUPS IN INDIA

The launch of action plan for startups in India on January 16th, 2016 ("**Action Plan**") has garnered an overwhelming response from the startup community and the investors alike. While the Action Plan had laid down a road map for wide ranging reforms to give a boost to the startup culture in India, the stakeholders eagerly awaited the fine print of these reform measures. Our analysis of the Action Plan is available at here. Soon after the announcement of Action Plan, the Ministry of Corporate Affairs, vide its notification dated January 22, 2016, had issued Companies (Incorporation) Amendment Rules, 2016 ("**Amendment Rules 2016**") to the existing Companies (Incorporation) Rules, 2014 ("**Principal Rules**") which has brought few significant changes to the Principal Rules. Amendment Rules 2016 is the second amendment to the Principal Rules in furtherance to its objectives of ease of business in India. Realizing the inefficiencies in the existing systems causing inordinate delays in the incorporation of entities, Government, in order to ease the incorporation process has come up with these changes. Our analysis of the Amendment Rules 2016 is available at here.

Subsequently, the Reserve Bank of India ("**RBI**") and the Labour and Employment department of the Government of India ("**Labour Department**") announced certain policy changes to foster an attractive environment for startups in India.

Most recently, the Department of Industrial Policy and Promotion ("**DIPP**") on February 17, 2016 notified[1] the definition of startup in line with the Action Plan, in order to bring uniformity in the identified enterprises ("**DIPP Notification**").

PROPOSALS PUT FORTH UNDER THE MONETARY POLICY

The RBI Governor in his statement on the sixth Bi-monthly Monetary Policy Statement, 2015-16 ("**Monetary Policy**") had laid out that in line with Government's Startup India initiative, the central bank will take steps to ease doing business and contribute to an ecosystem that is conducive for growth of startups.

Consequently, the RBI released a list of reforms that they intended to introduce. Most importantly, the RBI clarified that Foreign Venture Capital Investors ("**FVCI**") would now be able to invest in all startups regardless of the sector that the startup would fall under. This long required clarifications comes in the background of the RBI restricting FVCI from only investing in a list of permissible sectors. Now it appears that this restriction would be done away with and FVCIs to invest into startups irrespective of the sectors, subject to them not operating in otherwise prohibited sectors. We believe that this relaxation would be linked to the definition of startups as proposed by the Government as part of the Action Plan.

Further, the RBI also announced that it would permit transfer of shares or ownership with deferred considerations and facilities for escrow or indemnity arrangements for a period of 18 months. Deferred payments, escrows and indemnities are typically used to structure different types of transactions. For example deferred payments are often required when the payment of consideration is based on achieving certain milestones or completion of certain conditions subsequent. Currently, the law places restrictions on how such payments can be structured. It appears that the RBI will allow some flexibility in structuring these transactions as well. The notifications/circulars under the Foreign Exchange Management Act, 1999 ("**FEMA**"), notifying these changes is still awaited.

Another, relaxation announced by the RBI is the simplification of the process for dealing with delayed reporting of Foreign Direct Investment ("**FDI**") related transaction by building a penalty structure into the regulations itself. Further, the move to enable online submission of A2 forms for outward remittances on the basis of the form alone or with upload/ submission of document(s), depending on the nature of remittance is intended to provide ease in doing business involving foreign parties. In order help startups, the RBI has already created a dedicated mailbox to provide assistance and guidance to the startup sector. Further, the RBI has also permitted electronic reporting of investment and subsequent transactions on e-Biz platform only. As such, submission of physical forms has been discontinued with effect from February 8, 2016.

In addition to these measures, the RBI also announced that they were exploring some other reforms as well in consultation with the Government of India. These proposals include access to rupee denominated loans under External Commercial Borrowing ("**ECB**") framework with relaxations in respect of eligible lenders among other things, issuance of convertible notes under the FDI regime and streamlining overseas investment operations for startups.

The current ECB regime *inter alia* sets out various conditions for Indian companies raising loan from external borrowings including conditions relating to (i) eligible borrowers (ii) eligible lenders (iii) permitted end uses etc. The move to permit startups to avail ECB under a relaxed framework will open up an additional fund raising avenue without dilution of equity stake of the Founders. This is particularly important, considering the limited availability of

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venture debt in India. Further, streamlining of overseas investment operations will help the startups in setting up foreign subsidiaries and provide them with operational ease in terms of inflow and outflow of funds.

CLARIFICATIONS ISSUED BY THE RBI

In furtherance of the announcement under the Monetary Policy, the RBI had promised to clarify its stance on certain ambiguities which had arisen on matters that are already permissible under the existing regime. On February 11, 2016 the RBI issued clarifications relating to issuance of shares and acceptance of payments.

i. Issuance of shares (a) through Sweat Equity; and (b) against amounts owed;

In June 2015, the RBI had clarified its position in relation to issuance of shares through the Sweat Equity route, i.e. equity shares issued by a company to its directors or employees for consideration other than cash, for providing their know-how or making available rights in the nature of intellectual property rights or value additions subject to complying with the regulations issued under the Companies (Share Capital and Debentures) Rules, 2014 for unlisted Companies.

This clarification reiterates the position set out in the June 2015 notification. However, the notification has been worded so as to provide clarifications for '*issues related to issue of shares without cash payment by the investor through sweat equity or against any legitimate payment owed by the company remittance of which does not require any permission under FEMA, 1999.*'

While the intent behind this clarification was to reiterate the position set out in the June 2015 notification which allowed issuance of sweat equity shares to directors or employees, it is not clear as to whether the wording in this clarification would now mean that investors can also be issued sweat equity and it need not be restricted only to directors or employees. This may lead to some confusion as 'sweat equity' under the Companies Act, 2013 can only be given to employees and the directors of the company or a subsidiary or a holding company.

It has also been clarified that the Indian startups may issue shares against any other funds payable by the startup company. Whilst the RBI had permitted issuance of shares against any other funds payable by the investee company in 2014, this clarification has been specifically introduced in relation to startups.

This clarification is to provide for situations where the Indian startup has to make payments for use or acquisition of intellectual property rights, import of goods, payment of dividends, interest payments, consultancy fees, etc. However, such issuance of shares can only be done in terms of remittances which do not otherwise require prior permission of the Government of India or RBI under FEMA. Furthermore, such issuances shall also be subject to the Foreign Direct Investment policy, including sectoral caps, pricing guidelines, etc. and applicable tax laws.

Therefore, this clarification would now clear the air on issuance of shares by startup companies in lieu of payments to be made by them and would also allow them to access more sophisticated intellectual property which they would not otherwise be able to afford.

ii. Clarification relating to acceptance of payment on behalf of overseas subsidiaries

For startups intending to set up subsidiaries abroad, especially in the technology and information technology space, routing of foreign exchange earnings back to India was a huge challenge. To provide startups some respite in this regard, RBI has clarified as follows:

1. Startups with overseas subsidiaries is permitted to open a Foreign Currency Account ("**FCA**") abroad in order to pool the foreign exchange earnings out of the exports / sales made by such startup. Furthermore, the startups' overseas subsidiary has also been permitted to pool the receivables arising from the transactions with residents in India as well as with the non-residents into FCA opened abroad;

   However, the circular provides that the balances due to the Indian startup in the FCA should be repatriated to India within a period as applicable to realization of export proceeds, which currently stand at 9 (nine) months.

2. Moreover, a startup is also permitted to avail facilities provided by the 'online payment gateway service providers for realization of the receivables of its overseas subsidiary or for repatriating the balance funds in the foreign currency account, for a value not exceeding USD 10,000 (United State Dollars Ten Thousand). To maintain privity of contract and facilitate the above arrangement, the circular requires an appropriate contractual arrangement to be entered into between the startup, its overseas subsidiary and the concerned customers.

By way of a circular dated April 02, 2012, the RBI had allowed Indian companies to open, hold and maintain FCA abroad for the purpose of overseas direct investments subject to the certain terms and conditions. The conditions, amongst other things included: (a) utilization of the remittances sent to the FCA by the Indian party for making overseas direct investment into the joint ventures/ wholly owned subsidiaries abroad; (b) repatriation of any amount received in the account by way of dividend and / or other entitlements from the subsidiary, to the Indian entity within 30 days from the date of credit.

As a relaxation to the above, the clarification now allows Indian companies to directly pool the receivables not only of the overseas subsidiary but, also of the Indian startup entity. While the clarification also provides relaxation in terms of requiring repatriation of monies due to the Indian startup within 9 months, there is no clarity on the balances due to the overseas subsidiary. It is also not clear as to how the overseas subsidiary, which has raised the invoices on its Indian and non-resident clients, would account for the monies pooled directly in the FCA. It is also not clear if such monies can be utilized by the Indian startup abroad, or the monies can be remitted back from the FCA to the overseas subsidiary.

The RBI should clarify these points and should also come out with a circular, appropriately amending the RBI regulations pertaining to overseas direct investment, so as to clarify the position from the perspective of overseas subsidiary.

ANALYSIS

The circular is aimed at providing operational ease for startups with overseas subsidiaries and which deals with foreign customers and would enable Indian startups to route foreign exchange earnings through such overseas

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subsidiaries. However, it seems that the measures announced by the RBI have already been in place and it has clarified its application to startup companies.

REFORMS SUGGESTED BY THE LABOUR DEPARTMENT

The Labour Department on January 12, 2016 had issued directions to various regulatory organisations responsible for compliance with various labour laws including the Contract labour (Regulation and Abolition) Act, 1970; Employees' Provident Funds and Miscellaneous & Provisions Act, 1952 ("**EPF Act**"); and Employees' State Insurance Act, 1948; Industrial Disputes Act, 1947; Payment of Gratuity Act, 1972; the Trade Unions Act, 1926 ("**Proposal**").

The Proposal aims to provide the following relaxations to startup as defined under the Action Plan:

1. Submission of an online self-declaration instead of the provisions of inspection of establishments under labour laws by regulatory bodies, in the first year of incorporation; and
2. Filing of self-certified returns under the EPF Act.

Acting on the directions issued by the Labour Department, the Employees Provident Fund Organisation ("**EPFO**") on January 21, 2016 notified a circular ("**EPFO Circular**"): (a) exempting the startup enterprises from compliance under the EPF Act in relation to inspection of establishments and (b) permitting submission of self-certified compliance returns. The EPFO has further clarified that from the second year onwards up to three years from the setting up of the unit of such startups, the inspections may be permitted only on grounds of very credible and verifiable complaints of violations, filed before EPFO in writing and for which the approval has been obtained from Central Analysis and Intelligence Unit established by the EPFO.

ANALYSIS

These reforms are a step in the positive direction and in-line with Government of India's move to facilitate ease of doing business for startups. Compliances under labour laws usually involve long and cumbersome process. These reforms will help eliminate such delays.

DEFINITION OF STARTUP

In another development following the Action Plan, the DIPP has recently notified the definition of a startup and has also laid down a process for its recognition and eligibility for obtaining tax benefits. As per the DIPP Notification, an entity (i.e. a private limited company / limited liability partnership or a registered partnership firm) incorporated/ registered in India shall be considered as a 'startup':

1. Up to 5 years from the date of its incorporation/ registration,
2. If its turnover for any of the financial years has not exceeded INR 25 crores, and
3. It is working towards innovation, development, deployment or commercialization of new products, processes or services driven by technology or intellectual property.

However, the DIPP Notification provides that any such entity formed by splitting up or reconstruction of a business already in existence shall not be considered a 'startup'. 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;

Further, in line with the Action Plan, 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, which shall consist of the following members:

1. Joint Secretary, Department of Industrial Policy and Promotion,
2. Representative of Department of Science and Technology, and
3. Representative of Department of Biotechnology.

As per the DIPP Notification, a business would be covered under the definition of startup only if it aims to develop and commercialize (a) a new product or service; or (b) significantly improves an existing product, service or process that will create and add value for customers or the workflow. As such, the mere act of developing the following would not be covered under the definition of 'startup':

1. Products or services which do not have potential for commercialization; or
2. Undifferentiated products or services or processes; or
3. Products or services or processes with no or limited incremental value for customers or workflow.

The DIPP Notification also lays down the process of recognition as a 'startup'. Accordingly, the recognitions shall be through mobile application/ portal of the DIPP. For the purposes of making applications for being recognized as a startup, entities will be required to submit a simple application with any of following documents:

1. A recommendation (with regard to innovative nature of business), in a format specified by DIPP, from any Incubator established in a postgraduate college in India; or
2. A letter of support by any incubator which is funded (in relation to the project) from 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 Government of India; or
4. A letter of funding of not less than 20 per cent in equity by any Incubation Fund/ Angel Fund/ Private Equity Fund/ Accelerator/ Angel Network duly registered with SEBI that endorses innovative nature of the business; or
5. A letter of funding by 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 Office in areas affiliated with the nature of business being promoted.

ANALYSIS

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 fulfill these criteria. Further, 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 the 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.

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You can direct your queries or comments to the authors

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[1] Notification no. 113, The Gazette of India, dated February 17, 2016, Ministry of Commerce and Industry (Department of Industrial Policy and Promotion

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