Startup Ecosystem in India

India is one of the leading hotspots in the world in terms of the startup ecosystem. India has the third largest startup ecosystem in the world, expected to witness year over year growth of a consistent annual growth rate of 12-15%[1]. Trying times like these have shown some of the brightest stars in this world. Some of the leading companies in the world were founded when the economies worldwide were in deep recession. The one common thing proved by these examples is that human minds and intellect have been pushed to their maximum during these times and the end results have been nothing but wonderful to say the least. The ongoing pandemic would be no exception to it and some large corporates are likely to be formed during these times. Read on…

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Some of the leading companies founded during the recession include Netflix (1997, dot. com bubble), Airbnb (2008 recession), General Electric (1876, The Panic of 1873). The one common thing proved by these examples is that human minds and intellect have been pushed to their maximum during difficult times and the end results have been exceptional. The ongoing pandemic would be no exception to it and some large corporates are likely to be

[1] www.startupindia.gov.in

> This provides an incentive to these companies as some investors who have invested in the startup from the beginning can exit the company without having to pay tax on the amount received in excess of the fair value of the shares of the company and the company too can receive more funds for further expansion.

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India, the 3rd largest startup ecosystem in the world, has a lot of opportunities to capitalise on the abundance of ideas which may result into wonderful businesses. The mechanism for startups in India is regulated by the Department for Promotion of Industry and Internal Trade (DPIIT). Various benefits, tax as well as non-tax, are available to startups.

Now let us delve deeper into the regulatory bodies and statutory authorities providing various benefits to startups:

Department for Promotion of Industry and Internal Trade (DPIIT)

The DPIIT regulates all the startups in India. It gives recognition to the startups as such because of which startups are eligible to claim various benefits. The Startup India Initiative was announced by the Hon'ble Prime Minister of India on 15th August, 2015. The flagship initiative aims to build a strong eco-system for nurturing innovation and startups in the country that will drive sustainable economic growth and generate large scale employment opportunities. Further to this, an action plan for Startup India was unveiled by the Hon'ble Prime Minister of India on 16th January, 2016[2].

To claim the various benefits available to a Startup, the pre-dominant requirement is that the company/LLP/partnership firm should be recognized as such by DPIIT. The eligibility criteria for startup recognition as per DPIIT, is as follows[3]:

i. The Startup should be incorporated as a private limited company or registered as a partnership firm or a limited liability partnership (LLP).

ii. Turnover should be less than ₹100 crores in any of the previous financial years.

iii. An entity shall be considered as a Startup up to 10 years from the date of its incorporation.

iv. The Startup should be working towards innovation/improvement of existing products, services and processes and should have the potential to generate employment/ create wealth.

Note: An entity formed by splitting up or reconstruction of an existing business shall not be considered as 'Startup'.

Benefits to Startups under the Income Tax Act, 1961

Definition of **"Eligible Startup"** and **"Eligible Business"** under the Income-tax Act, 1961:

"Eligible Startup" means a company or a limited liability partnership engaged in **"eligible business"** which fulfils the following conditions namely

1. Incorporated on or after 01st April, 2016 but before 01st April, 2021.

2. The total turnover of the business doesn't exceed ₹100 Crores[4] in the previous year relevant to the Assessment Year for which deduction is being claimed.

3. It holds a certificate of eligible business from the Inter-Ministerial Board of Certification as notified in the Official Gazette by the Central Government.

"Eligible business" means a business carried out by an eligible startup engaged in innovation, development or improvement of products or processes or services or a scalable business model with a high potential of employment

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2 *Ibid*

3 *G.S.R. notification 127 (E) dated February 19,2019*

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generation or wealth creation.

The various sections/provisions of the Income-tax Act, 1961 which give benefits to startups are as follows:

1. **Section 80-IAC:** The gross total income of an eligible startup from an eligible business will be allowed a deduction of 100% for a period of three consecutive assessment years from any of the 10 assessment years[5] starting from assessment year relevant to the previous year in which the company was first incorporated. This period of three assessment years would be at the option of the assessee. It has to be noted by the assessee that only gross total income relating to the eligible business will be allowed as deduction under this section. Any income other than income from eligible business would not be allowed as deduction.

2. **Section 54GB:** When the eligible assessee (being Individual or HUF) transfers any residential property (being a house or a plot of land and should qualify as a long term capital asset) and out of the net consideration[6] received, subscribes for the shares of an eligible company before furnishing return of income before due date u/s 139(1) and the eligible company within one year from date of subscription by the assessee, purchases a new asset, than the capital gains arising on such residential house property will be exempted from tax. However, the capital gains will be exempted on a proportionate basis i.e. if amount of cost of acquisition of new asset is less than consideration, than only that proportion of capital gains which bears to the amount invested in new asset as divided by net consideration will be exempt from tax and the balance would be taxable. However, if amount of cost of acquisition of new asset equals to or exceeds net consideration, then the entire capital gains will be exempt. The eligible assessee should have at least 25% shareholding or 25% voting power in the company[7]. However, the shares subscribed to by the eligible assessee in the new company have to be held for a minimum period of five years and the new asset acquired by the new company also have to be held for a minimum period of five years. If the shares are sold by assessee before five years or new asset acquired by the company is sold within a period of five years, then the capital gains exempted earlier will become taxable.

3. **Section 56(2)(viib):** This section provides for taxation of income of such amount received for issue of shares to a Resident which exceeds the fair market value of such shares. However, for such amount to be taxed as income, the fair market value of the share should be more than its face value. However, such excess amount would not be taxable as such if such amount is received by a venture capital undertaking[8] from a venture capital company or a venture capital fund. This provides an incentive

[4] *Substituted for ₹25 Crores by the Finance Act,2020 w.e.f. 01-04-2021.*
[5] *Substituted for 7 assessment years by the Finance Act,2020 w.e.f. 01-04-2021*
[6] *Net consideration = Consideration received – expenses for transfer*
[7] *Substituted for 50% by the Finance (No. 2) Act, 2019, w.e.f. 01-04-2020.*
[8] *"Venture Capital Undertaking" as per Alternative Investment Funds Regulations means a domestic company which is not listed on a recognized stock exchange in India at the time of investment and is engaged in the business for providing services, production or manufacture of article or things and does not include companies engaged in the following sectors/activities viz. non-banking financial companies, gold financing, activities not permitted under industrial policy of Government of India and any other activity which may be specified by SEBI in consultation with Government of India.*

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Difference in Startup Recognition as per DPIIT vis-à-vis Income-Tax Act, 1961

1. DPIIT recognises a partnership firm as a Startup whereas Income-tax Act, 1961 ("the Act") doesn't recognise a partnership firm as a startup.
2. DPIIT recognises foreign LLPs as startups as well. However, the Act is silent on whether foreign LLPs too would be eligible to be recognised as startups if other conditions are satisfied.

Differences in policies adopted by Income tax Department and DPIIT for this flagship initiative of the Government of India be streamlined so that startup as per the Income-tax Act, 1961 and as well as DPIIT are at the same page. Uniformity in criteria in terms of startup recognition would be more beneficial overall including tax benefits.

Concluding Remarks

Overall, the Indian Startup ecosystem appears to be booming in the years to come. With the appropriate measures taken by the Government, both the Government as well as the startups would benefit. Apart from the various tax benefits given by the Government to startups, it also provides various other services to startups like self-certification under labour and environment laws, faster exit for startups[9], etc. To provide equity funding support for development and growth of innovation driven startups, the GOI has also set aside a corpus fund of INR 10,000 crores managed by SIDBI. The fund is in the nature of Fund of Funds, which means the GOI participates in the capital of SEBI registered Venture Funds, who invest twice the amount in startups.

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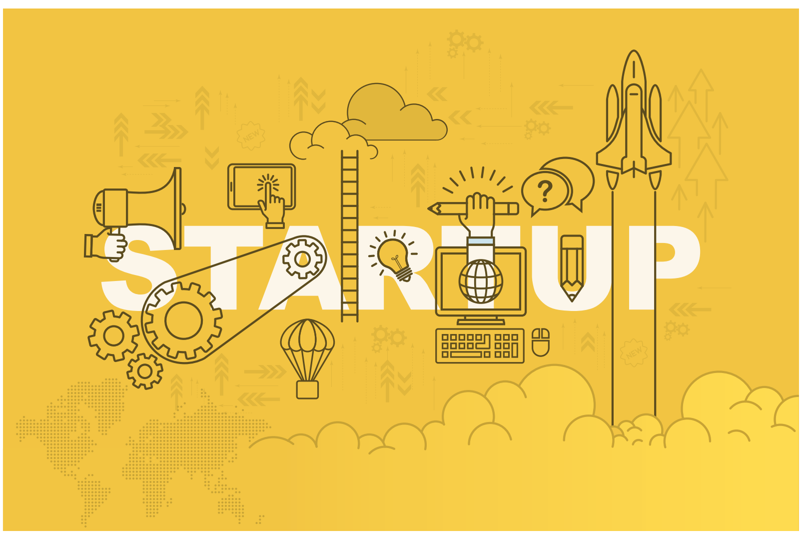
All the above measures taken by the Government only emphasise the Government's belief in the Startup ecosystem and in the minds, ideas and capabilities of Indians to create wonders. Undoubtedly, India will be instrumental in upspring of unicorns in the years to come.



[9] *The Ministry of Corporate Affairs (MCA) has notified Startups as 'fast track firms' enabling them to wind up operations within 90 days vis-à-vis 180 days for other companies.*