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How To Startup? Legal Perspective

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Startups Recognized By Govt.

An entity will be identified as a 'Startup' by the Government of India under the DIPP Notification dated 11.04.2018:

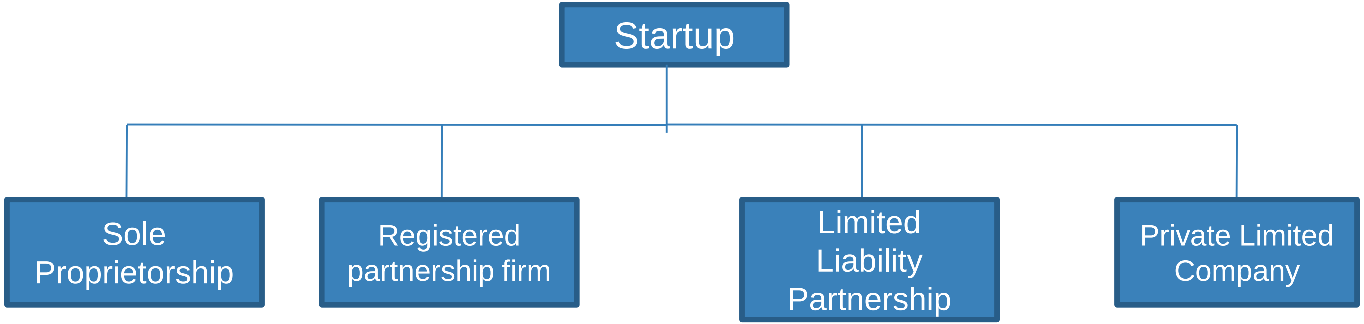
- If it is a private limited company, registered partnership firm or limited liability partnership
- Upto a period of **7 years** from date of incorporation/registration (in case of startups in biotechnology sector , the period will extend upto **10 years** from date of incorporation/registration);
- Turnover does not exceed **25 crore** in the last **5** financial years,
- Entity is working towards innovation, development or improvement of products or processes or services, or if it is a scalable business model with a high potential of employment generation or wealth creation.
- The startup has to fill online application on the mobile app or portal of the DIPP below:

Website Link: https://www.startupindia.gov.in/content/sih/en/startupgov/startup-recognition-page.html

An entity formed as a result of splitting up or reconstruction of an existing business will not be recognized as a startup.

Setting Up A Startup

Startup can be set up in the following manner:



Most startups prefer the structure of a **private limited company** due to the following advantages-

- Eligible for tax exemption on profits and also on investments above fair market valuation.
- Ability to conveniently raise funds through issue of equity shares, preference shares and debentures.

STRUCTURE OF PPT

I. Licenses and Agreements
- i) Statutory Licenses
- ii)Regulatory Compliance
- iii)Contracts with service providers

II. Benefits available to Startups
- i) Registration of IPR
- ii) Self Certification
- iii) Relaxation under Companies Act
- iv)Tax Exemptions under Income Tax Act
- v) Fast Track Insolvency Resolution Process

III. Fund Raising by Startups
- i) AIFs
- ii) ECBs
- iii) Shares and Debentures
- iv) Term Sheet
- v) Shareholders Agreement

IV. Executive Compensation & ESOP
- i) Employee Agreements
- ii) ESOP

Statutory Licenses

Startups generally need below licenses after establishing their business:

- PAN (Permanent Account Number)
- TAN (Tax Deduction Account Number)
- GSTIN (Goods and Service Tax Identification Number)
- Importer Exporter Code- If the startup is dealing in import or export of any product/service.
- Shops and Establishments Act- The registration needs to be acquired as per the respective State Act.
- EPF (Employee Provident Fund Act)-If more than 20 people are employed.
- ESIC (Employee State Insurance Act)- If more than 10 people are employed (20 people in Maharashtra and Chhattisgarh).

Regulatory Compliance

Startup companies have to comply with regulatory compliance as per the Companies Act, 2013, including the following:

- Form INC-1 for reservation of name of the company.
- Form DIR-12 for appointment of directors.
- Form CHG-7 Register of charges that the company has not created any charge on its properties.
- Form MGT-1 Register of members
- Form MGT-2 Register of debenture holders
- Form DPT-3 Return of deposits
- Annual return Form MGT-7- Annual return form can now be signed by a director of the company in the absence of a company secretary.
- Minutes of Meetings Book

Contracts with Service Providers/Vendors

The Startup will avail services from various service providers/vendors and execute service agreements/contracts with them. **Proper stamp duty should be paid on all agreements**. The service agreement should contain the following clauses-

1. Non-disclosure of confidential information
2. Obligations of service provider
3. Restriction on use of Intellectual Property Rights
4. Payment terms
5. Indemnity
6. Force Majeure
7. Exclusivity and Non-Solicitation
8. Term and Termination of agreement
9. Dispute Resolution and Governing Law
10. Damages and Equitable Relief
11. Representations and Warranties

Registration of Intellectual Property Rights

- Startups should get their IPR registered under the relevant Intellectual Property acts respectively to protect from infringement.
- **Trademark** includes a name, design, symbol, phrase, logo, image or a combination of these elements.
- **Examples of Registered Trademark-**

PEPSI

SAMSUNG

- **Patent** includes a new product or process involving an inventive step and capable of industrial application.
- **Example of Registered Patent-** Pepsico was granted a Patent For **A Self-Stable Beverage Composition.**
- Startups are eligible for availing the benefits under Startups Intellectual Property Protection ("SIPP") scheme after they have obtained the certificate of recognition.
- Startups are eligible for 80% reduction in patent registration fee and 50% reduction in trademark registration fee.

Self-Certification Compliance With Certain Labour and Environmental Laws

The Government has now permitted Startups to self-certify compliance with 6 labour laws and 3 environmental laws for a period of 5 years from the date of incorporation.

Labour Laws:

- 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
- The Employees' State Insurance Act, 1948

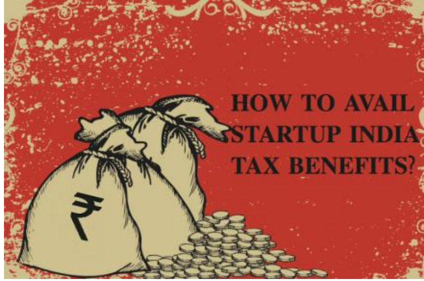
Environment Laws:

- 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

Relaxation under Companies Act 2013

- Need not include cash flow statements in its financial statements.
- Permitted to hold 2 (two) board meetings in a calendar year i.e. once in 6 months, provided that the gap between two consecutive board meetings is at least 90 days.
- Interested directors will be counted as quorum for board meetings, provided they disclose their interest to the board beforehand.
- The annual return will include only the aggregate of remuneration drawn by directors (not key managerial personnel).
- Can accept deposit from its members for a period of 5 years from its incorporation.

Tax Benefits to Startups



1. Exemption on Profits and Gains of Startup

- Eligible to apply to the Inter-Ministerial Board for full deduction on capital gains from business under section 80-IAC of Income Tax Act, 1961.
- A startup can avail upto 100% tax exemption for 3 years out of 7 years if the following conditions are fulfilled-

  (a) It is not formed by splitting up, or the reconstruction, of a business already in existence.

  (b) It is not formed by the transfer to a new business of machinery or plant previously used for any purpose.

- The following criteria should be fulfilled:

  (a) The startup should be a private limited company or a limited liability partnership.

  (b) The startup has to be incorporated on or after 1st April 2016 but before 1st April , 2021.

  (c) The startup shall make application Form-1 along with necessary documents.

2. Exemption from Angel Tax

Angel tax is a tax levied on investments made by external investors in startups in which only the amount that is considered above fair value valuation of the startup is taxable under Section 56 of the Income Tax Act, 1961.

A Startup, being a private limited company, shall be eligible to apply for approval for the purposes of section 56 on satisfying following conditions:

- Aggregate amount of paid up share capital and share premium after the proposed issue of shares does not exceed 10 crores.
- The investor/ proposed investor should have:

  (a) An average returned income of 25 lakhs or more for the preceding 3 financial years.

  (b) The net worth of 2 crores or more as on the last date of the preceding financial year,
- The startup has obtained a report from a merchant banker specifying the fair market value of shares in accordance with Rule 11UA of the Income-tax Rules, 1962.

3. Exemption On Capital Gains From Investments In Specified Funds

- Section 54EE of Income Tax Act provides exemption on capital gain that has arisen from a long term capital asset and
- Where the startup has, within a period of six months, invested the whole or part of the capital gain,
- **Provided** that the investment made on or after the 1st day of April, 2016, in the long-term specified asset by an assessee during any financial year does not exceed fifty lakh rupees. no tax will be charged under section 45 of Income Tax Act if:

(*a*) if the cost of the long-term specified asset is not less than the capital gain arising from the transfer of the original asset, the whole of such capital gain shall not be charged;

(*b*) if the cost of the long-term specified asset is less than the capital gain arising from the transfer of the original asset, so much of the capital gain as bears to the whole of the capital gain the same proportion as the cost of acquisition of the long-term specified asset bears to the whole of the capital gain, shall not be charged under section 45.

4. Exemption On Capital Gain from Residential Property

- Section 54GB provide exemption from tax on long term capital gains in respect of the gains arising on account of transfer of a residential property, if such capital gains are invested in subscription of shares of a company which qualifies to be a small or medium enterprise under the Micro, Small and Medium Enterprises Act, 2006 subject to other conditions specified therein.

- The investments in computers or computer software in case of technology driven startups so certified by the Inter-Ministerial Board of Certification notified by the Central Government in the official Gazette shall also be eligible to claim tax exemption.

Insolvency Resolution Process For Startups

The Central Government has notified section 55 to 58 under Chapter IV of the Insolvency and Bankruptcy Code and provided an application for fast track corporate insolvency resolution process for corporate debtors. A startup (other than the a partnership firm) is also considered to be a corporate debtor.

- **Section 56** of the Code provides a time period of **90 days** from the fast track commencement date to complete the insolvency resolution process.
- The Adjudicating Authority may, not more than once, extend this time period for not more than **45 days** on an application filed by the resolution professional.
- Such extension can be applied for only when the committee of creditors, in a resolution passed and supported by a vote of 75% of the voting share, is of the opinion that the fast track process cannot be completed within the stipulated 90 days.

Methods For Raising Funds-I

Startups can raise funds in a variety of ways including:-

Alternative Investment Funds (AIF)- Alternative Investment Fund or AIF means any fund established or incorporated in India which is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors.

- **Venture Capital Funds ("VCF")-**VCF is category I of AIF that invests in startups or early stage ventures.

- **Angel Funds-** It is a sub-category of VCF that raises funds from angel investors and invests in startups.

- **Fund of Funds-** It is an AIF which invests in other AIFs. The Government has approved the establishment of 'Fund of Funds for Startups' (FFS) at SIDBI for contribution to various AIFs with a corpus of INR 10,000 crore.

- **SEBI registered AIFs-** 021 Capital Trust, 1 Funds Trust, 3F Ventures, Aavishkaar Bharat Fund, A[illegible]e Lansdowne India Investment Fund, Accuracap Prime Opportunities Fund, Adi Trust, Aditya Birla Real Esta[illegible] Debt Fund, Aditya Birla Special Situations Fund etc.

Methods For Raising Funds-II

External Commercial Borrowings ("ECB")- The Government of India has permitted AD Category-I banks to allow Startups to raise ECB under the following framework:

a. **Eligibility**: An entity recognized as a Startup by the Central Government as on date of raising ECB.

b. **Maturity**: Minimum average maturity period will be 3 years.

c. **Recognized lender**: Lender / investor shall be a resident of a country who is either a member of Financial Action Task Force (FATF) or a member of a FATF-Style Regional Bodies; and shall not be from a country identified in the public statement of the FATF as:

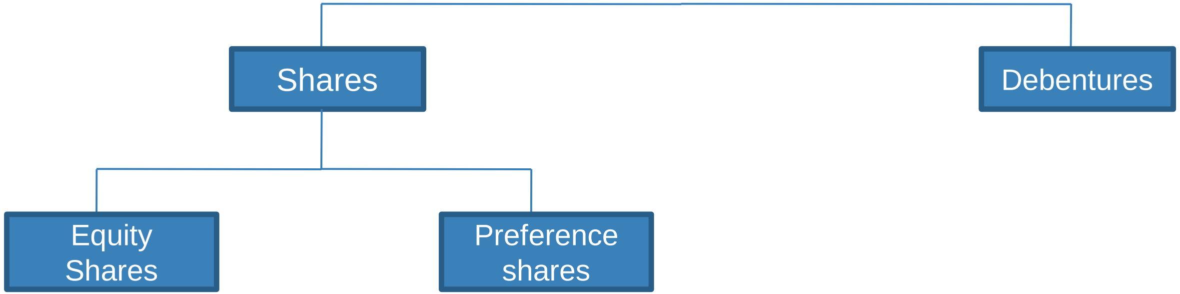
A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies

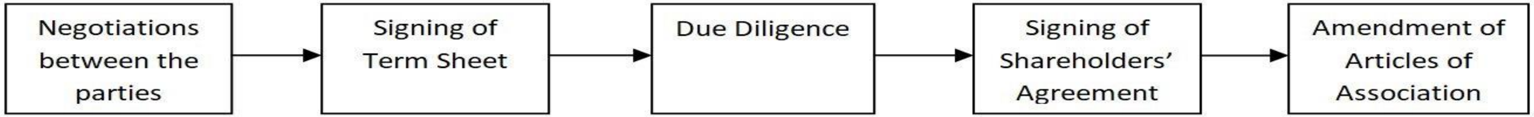
Exclusion: *Overseas branches/subsidiaries of Indian banks and overseas wholly owned subsidiary / joint venture of an Indian company will, however, not be considered as recognized lenders under this framework.*

Instruments & Process For Raising Funds

Instruments for raising funds:



Process for raising funds:



Term Sheet For Issue of Shares

A terms is a non-binding agreement setting forth the basic terms and conditions under which an investment will be made. Preliminary agreement between startup and investor should include the following clauses:

1. **Valuation of the Company-** The total pre-money valuation of the company for the purpose of investors before the allotment is made.
2. **Number of shares and price per share-** The number of shares and price on which the shares are being allotted to the investors.
3. **Dividend-** The amount of dividend offered to the investors on their shares.
4. **Conditions Precedent to the allotment of shares-** Conditions which have to be fulfilled before the allotment is made to the investors.
5. **Conditions Subsequent to the allotment of shares-**Conditions which have to be fulfilled after the allotment is made.
6. **Exclusivity-** The company agrees to negotiate the transaction with the investors on an exclusive basis, generally for a period of 45-60 business days from the signing of the term sheet.

Shareholder's Agreement Clauses

When shares are allotted, the company usually signs a shareholders agreement with the investors. The clauses that are included in a shareholders agreement include:-

1. **Pre-emptive rights-** Pre-emptive rights enable the investors to purchase additional shares in the subsequent round of funding raised by the Company to prevent dilution of their pro-rata shareholding.
2. **Right of First Offer-** Right of first offer gives the investors the right to purchase the shares of the selling shareholders who, while selling their shares, have the obligation to first offer the shares to the other shareholders before offering to sell to a third party.
3. **Ratcheting-** Full ratchet is an anti-dilution provision that, for any shares of common stock sold by a company after the issuing of an option (or convertible security), applies the lowest sale price as being the adjusted option price or conversion ratio for existing shareholders.

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4. **Tag-Along Rights-** If a founder sells his stake in the company, tag-along right gives the investor the right to join the transaction and sell their stake in the company.
5. **Affirmative Rights-**These rights are the protective or veto rights granted to certain investors in matters pertaining to the company including right to appoint a director.
6. **Liquidation Preference-** Liquidation preference establishes that certain investors receive their investment money back first before the founders on the occurrence of a liquidation event.
7. **Arbitration and Governing Law-** Companies usually decide to resolve disputes through arbitration and also decide upon the governing law and jurisdiction of courts.

Executive Compensation

The Startup should execute employment agreements with all the employees. The employment agreement generally contains the following clauses-

1. Remuneration
2. Eligibility for ESOP
3. Code of Conduct
4. Non-disclosure of confidential information by employees
5. Termination of Employment
6. Ownership of Intellectual Property Rights by the Employer
7. Indemnity
8. Non-Compete
9. Non-Solicitation
10. Dispute Resolution and Governing Law

Employee Stock Option Plan

ESOP (Employee Stock Option Plan) – Companies provide employees with the option of stock ownership by offering them equity shares.

- A company can issue shares to employees under ESOP scheme only after the approval of shareholders by passing a special resolution.
- There shall be a minimum period of one year between the granting of option and vesting of option.
- No shares under ESOP scheme will be issued to an independent director.
- The Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.
- The amount, if any, payable by the employees, at the time of grant of option-

(a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

(b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

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