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STARTUP FUNDING IN INDIA: LEGAL AND REGULATORY CHALLENGES IN VENTURE CAPITAL AND PRIVATE EQUITY INVESTMENTS

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ABSTRACT

This article examines the legal and regulatory framework governing startup funding in India, with particular emphasis on venture capital (VC) and private equity (PE) investments. As India continues to emerge as one of the world's largest startup ecosystems, the regulatory environment has become increasingly complex, involving the interplay of the Companies Act, 2013, the Foreign Exchange Management Act (FEMA), SEBI regulations, foreign direct investment (FDI) policy, and taxation laws. The article analyses key legal challenges associated with foreign investment, Alternative Investment Funds (AIFs), taxation reforms, corporate governance, minority shareholder protection, exit mechanisms, and due diligence in startup transactions. It further explores recent regulatory developments, including the abolition of the angel tax, amendments to AIF regulations, and changes in overseas investment and FDI policies, highlighting their impact on founders and investors. The discussion also emphasizes the importance of carefully drafted contractual protections, compliance with evolving data protection laws, and effective risk allocation in investment agreements. The article concludes that while recent reforms have improved India's investment climate, continuous regulatory changes require startups and investors to adopt a proactive and compliance-oriented approach. A stable, transparent, and predictable legal framework will be essential to sustaining investor confidence and supporting the long-term growth of India's startup ecosystem.

INTRODUCTION

India has, over the past decade, emerged as the world's third-largest startup ecosystem, with venture capital and private equity inflows fuelling the rise of a substantial pool of unicorn companies across technology, fintech, healthcare, and consumer sectors. Yet, this growth story has unfolded against a regulatory backdrop that is anything but static. Startup funding transactions in India sit at the intersection of company law, securities regulation, foreign exchange control, and tax law[1], each administered by a different regulator with its own compliance architecture and timeline for reform. For founders and investors alike, navigating this overlapping framework, from the moment a term sheet is signed to the eventual exit, has become as much a legal exercise as a commercial one. This article examines the principal legal and regulatory challenges that shape venture capital and private equity investment in Indian startups, focusing on foreign investment control, securities regulation of investment vehicles, taxation, and the contractual mechanics of exit.

THE FOREIGN INVESTMENT FRAMEWORK: FEMA AND FDI POLICY

A substantial share of venture and private equity capital flowing into Indian startups originates from offshore funds, and any such inflow is governed by the Foreign Exchange Management Act, 1999, and the subordinate Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, read with the Consolidated FDI Policy[2]. Most startup sectors fall under the automatic route, permitting foreign investment without prior government approval, subject to sectoral caps and pricing guidelines. However, the entry route is not the only consideration. Following the amendment introduced by Press Note 3 of 2020, any investment, direct or indirect, beneficial ownership of which vests in an entity situated in a country sharing a land border with India, requires prior government approval regardless of sector[3]. This amendment, introduced in response to concerns over opportunistic acquisitions during the COVID-19 pandemic, has had an outsized practical impact on startup funding, since many global venture funds have limited partners or co-investors located in such jurisdictions, requiring careful diligence on the ultimate beneficial ownership chain before a round can close. The framework has continued to

[1]The Companies Act, No. 18 of 2013, India Code; The Securities and Exchange Board of India Act, No. 15 of 1992, India Code; The Foreign Exchange Management Act, No. 42 of 1999, India Code.
[2]Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, India Code; Consolidated FDI Policy Circular of 2020, Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India (Oct. 15, 2020).
[3]Press Note No. 3 (2020 Series), Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India (Apr. 17, 2020).

evolve since, with subsequent press notes refining the definition of beneficial ownership and the scope of affected transactions[4], underscoring that founders and investors cannot treat foreign investment compliance as a one-time check; it requires monitoring through the life of the investment, including at subsequent funding rounds and secondary transfers.

A related and recurring challenge is the prohibition on round-tripping, where capital is routed out of India into an offshore vehicle and subsequently reinvested back into an Indian entity, often to access more favourable tax treatment, simplify cap tables, or facilitate offshore listing. The Reserve Bank of India's revised overseas investment framework, introduced in 2022, brought clarity to structures that were previously regulated through informal FAQs rather than codified rules, but it retained strict layering restrictions, prohibiting structures resulting in more than two layers of subsidiaries between the Indian investment and the foreign entity[5]. Startups seeking to flip their holding structure offshore, a common precursor to raising capital from foreign funds that prefer investing in entities incorporated in jurisdictions such as Singapore or Delaware, must structure such flips carefully to avoid falling foul of these restrictions, in addition to satisfying separate approval requirements under the Companies Act for outbound mergers and capital reduction.

SEBI REGULATION OF INVESTMENT VEHICLES

Most domestic venture capital and private equity funds operating in India are structured and registered as Alternative Investment Funds under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012[6], which classify funds into three categories. Category I AIFs, which include venture capital funds, angel funds, and infrastructure funds, receive certain regulatory incentives in recognition of their role in channelling capital to economically desirable sectors; Category II AIFs cover private equity and debt funds that do not undertake leverage other than for day-to-day operational requirements; and Category III AIFs, including hedge funds, may employ complex trading strategies and leverage. This categorisation carries real legal consequences, since each category is subject to differing investment restrictions, leverage limits, and reporting obligations.

The regulatory architecture governing AIFs has itself been in a state of near-continuous revision. The most recent material change, introduced through the SEBI (Alternative

[4]Press Note No. 2 (2026 Series), Department for Promotion of Industry and Internal Trade, Ministry of Commerce and Industry, Government of India.
[5]Foreign Exchange Management (Overseas Investment) Rules, 2022, r. 19(3), India Code.
[6]Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, India Code.

Investment Funds) (Second Amendment) Regulations, 2025[7], established a formal framework for co-investment by Category I and II AIFs, allowing accredited investors to invest alongside the main fund in a specific investee company through a dedicated co-investment vehicle, and separately re-categorised angel funds as a distinct sub-category of Category I AIFs restricted to raising capital exclusively from accredited investors. For startups and fund managers structuring early-stage rounds, this means that the very definition of who may participate as an angel investor, and the procedural requirements for accepting their capital, has shifted meaningfully within a short span, requiring continuous monitoring of SEBI's regulatory calendar rather than reliance on settled practice.

Beyond fund-level regulation, SEBI's Issue of Capital and Disclosure Requirements Regulations and the broader framework for listed companies become relevant at a later stage of the startup lifecycle, particularly as companies approach an initial public offering and must reconcile the rights granted to venture and private equity investors under earlier shareholder agreements, such as anti-dilution protections, board nomination rights, and liquidation preferences, with the disclosure and governance norms applicable to listed entities. This reconciliation is frequently a source of negotiation friction in the run-up to a public listing, since several investor protections that are standard in private rounds are incompatible with or require modification for a listed company structure.

TAXATION: A SHIFTING LANDSCAPE

Taxation has historically been one of the most contentious aspects of startup fundraising in India, with the so-called angel tax under Section 56(2)(viib) of the Income Tax Act, 1961, standing as the most prominent example[8]. This provision treated any share premium received by an unlisted company in excess of the fair market value of its shares as taxable income, ostensibly to curb the laundering of unaccounted money through inflated startup valuations. In practice, the provision became a significant compliance burden for legitimate startups, given the absence of a single objective valuation methodology and the resulting scope for disputes with assessing officers over fair market value. After more than a decade of incremental relaxations, including exemptions for DPIIT-recognised startups meeting specified conditions, the provision was finally rendered inapplicable with effect from the assessment year 2025-26

[7]Securities and Exchange Board of India (Alternative Investment Funds) (Second Amendment) Regulations, 2025, Notification No. SEBI/LAD-NRO/GN/2025/265 (Sept. 8, 2025).
[8]Income Tax Act, No. 43 of 1961, § 56(2)(viib), India Code (omitted by the Finance (No. 2) Act, 2024, with effect from Apr. 1, 2025).

pursuant to the Finance (No. 2) Act, 2024[9], a reform widely welcomed by the startup ecosystem, though pending investigations and disputes relating to periods before the amendment remain unaffected by the change.

Separately, the taxation of AIFs themselves continues to generate planning complexity. Category I and II AIFs enjoy pass-through tax treatment under Section 115UB of the Income Tax Act, meaning that income earned by the fund, other than business income, is taxed in the hands of investors rather than at the fund level[10], but the precise character of that income, whether as capital gains or business income, has historically been a point of ambiguity and litigation. Recent amendments have sought to clarify that gains from securities held by such funds are to be treated as capital gains in the hands of investors, removing a long-standing source of uncertainty, though questions regarding the treatment of carried interest paid to fund managers, and its characterisation for tax purposes, remain a live area of debate among practitioners and continue to be refined through subsequent clarifications.

CORPORATE GOVERNANCE AND MINORITY INVESTOR PROTECTION

Venture capital and private equity investors typically negotiate for board representation, information rights, and protective provisions requiring their consent for specified corporate actions, all embedded within shareholders' agreements that sit alongside the company's articles of association. The legal robustness of these arrangements depends significantly on ensuring consistency between the shareholders' agreement and the articles, since Indian courts have generally held that provisions in a shareholders' agreement that are not mirrored in the articles may not be enforceable against the company itself, only between the contracting parties. This has practical implications for protective provisions and exit rights, which founders and investors must ensure are appropriately reflected in the constitutional documents of the company, not merely in a separate contractual instrument.

The boundaries of permissible governance intervention by minority investors were tested prominently in Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd.[11], where the Supreme Court clarified that the removal of a director or chairman through a validly passed board resolution does not, without more, constitute oppression or mismanagement under Sections 241 and 242 of the Companies Act, 2013[12], reinforcing that tribunals must exercise

[9]Finance (No. 2) Act, 2024, cl. 23, India Code.
[10]Income Tax Act, No. 43 of 1961, § 115UB, India Code, as amended by the Finance Act, 2025.
[11]Tata Consultancy Services Ltd. v. Cyrus Investments Pvt. Ltd., (2021) 9 SCC 449 (India).
[12]The Companies Act, No. 18 of 2013, §§ 241-242, India Code.

considerable restraint before second-guessing genuine commercial decisions taken by a board. While that dispute arose in the context of a large diversified conglomerate rather than a venture-backed startup, its reasoning is directly relevant to startup governance disputes, since founders and investors alike increasingly invoke oppression and mismanagement proceedings when boardroom relationships break down, and the judgment signals that such proceedings face a meaningfully high threshold before tribunals will interfere with board-level decision-making.

EXIT MECHANISMS AND CONTRACTUAL CHALLENGES

Exit remains the most commercially sensitive, and frequently the most litigated, aspect of venture and private equity investment in India. Drag-along rights, which permit majority shareholders to compel minority shareholders to join in a sale of the company, and tag-along rights, which permit minority shareholders to participate in a sale negotiated by the majority, are standard features of shareholder agreements, but their enforceability depends on careful drafting and, as noted above, reflection in the articles of association. Put options, under which an investor may require the company or its promoters to buy back their shares at a predetermined price or formula, have faced a more uncertain legal history in India, with earlier judicial pronouncements questioning whether such options amount to impermissible forward contracts in securities. While subsequent regulatory clarifications and amendments to the relevant securities contracts framework have eased this concern for options settled through actual delivery of shares, the valuation mechanics, timelines, and triggering events attached to such options remain a frequent source of negotiation and, on occasion, litigation between founders and financial investors when the underlying business does not perform as anticipated.

A further layer of complexity arises when the exit involves a sale to or merger with a foreign acquirer, or where investors seek to list the company on an overseas stock exchange. Each such pathway carries its own approval requirements, ranging from RBI compounding for delayed reporting of foreign investment transactions to the evolving but still developing framework for direct overseas listing by Indian companies, and the absence of complete regulatory certainty on some of these pathways continues to lengthen exit timelines and increase transaction costs for venture and private equity investors.

DUE DILIGENCE AND CONTRACTUAL RISK ALLOCATION

Legal due diligence in Indian startup transactions presents its own distinct set of challenges, particularly because early and growth-stage companies frequently carry latent compliance gaps accumulated during periods of rapid scaling, when governance and regulatory formalities often took a back seat to growth. Common issues uncovered during diligence include delayed or incomplete filings with the Registrar of Companies, non-compliance with the erstwhile foreign investment reporting timelines, inconsistent ESOP documentation, and labour law registrations that have not kept pace with headcount growth across multiple states. Investors typically respond to such findings not by abandoning the transaction but by allocating the associated risk contractually, through representations and warranties given by the founders and the company, coupled with indemnity provisions that survive closing for a specified period and are often backed by an escrow or holdback mechanism.

The negotiation of these provisions, particularly the scope of warranties, the cap and basket thresholds for indemnity claims, and the survival period for tax-related warranties, has become increasingly standardised in Indian venture transactions, drawing on market practice developed over the past decade, yet still requires careful tailoring to the specific risk profile of each target. A related and increasingly significant area of diligence concerns data protection compliance, particularly following the enactment of the Digital Personal Data Protection Act, 2023, which imposes fresh obligations on companies handling personal data of Indian users and has begun to feature prominently in technology-sector diligence checklists, even though the subordinate rules and enforcement mechanisms under the statute continue to be operationalised. Investors are increasingly requiring specific warranties and, in some cases, pre-closing remediation covenants addressing data protection compliance before agreeing to fund a round, reflecting the growing maturity of regulatory risk allocation in Indian venture transactions.

CONCLUSION

The legal and regulatory framework governing startup funding in India reflects an ecosystem still very much in the process of maturing, where significant reforms, such as the abolition of angel tax and the liberalisation of the overseas investment regime, sit alongside areas of continuing uncertainty, including the tax treatment of carried interest, the enforceability of certain exit mechanisms, and the practical compliance burden of beneficial ownership tracing under the land-border restriction. For founders and investors, the practical lesson is that regulatory compliance in startup funding is not a static checklist completed at the time of a financing round, but an ongoing obligation that must be revisited as SEBI, the RBI, and the tax authorities continue to recalibrate the framework. As India's startup ecosystem continues to scale and increasingly looks toward public markets and cross-border transactions for its next phase of growth, the coherence and predictability of this regulatory architecture will likely prove just as consequential to its continued success as the availability of capital itself.