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LEGAL FRAMEWORK OF INDIAN STARTUPS: REGULATORY HURDLES AND COMPLIANCE PROBLEMS

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Introduction

The Indian startup industry is known for being the third largest in the world. It consists of more than 100 unicorns and many successful innovations. However, behind all these achievements, there is an intricate legal framework that entrepreneurs face upon the establishment of a startup company. Although some policies such as Startup India are implemented with the goal of easing the regulation process, there are still a number of regulatory challenges that influence the reality of startups. This blog post will discuss the legal framework of Indian startups as well as its friction areas.

Legal Framework – A Quilt, Not a Law Code

In contrast to the other jurisdictions which adopt a single "Startup Law," in India, regulation of startups happens in a quilt of legislation. For example, the Companies Act, 2013 governs incorporation and governance; the Limited Liability Partnership Act, 2008 gives the option of the limited liability partnership form of organization; the income tax and GST regimes are governed by Income Tax Act, 1961 and the GST laws respectively; and regulations specific to different industries for example, regulations of SEBI or RBI are applicable depending on the type of business.

Recognition of the startups as per the Startup India program by the Department for Promotion of Industry and Internal Trade (DPIIT) makes the startups eligible for benefits like tax exemptions and relaxed compliance rules. However, it's not automatic but based on certain criteria, which excludes many startups.

This structure leads to the problem that the entrepreneurs refer to as "layering of compliance."

Regulatory Issues: Where the System Inhibits Innovation

A recurring problem is that of regulatory uncertainty. Companies working in new age industries such as fintech, edtech and crypto are constantly operating in the grey area of law. For example, the RBI's back and forth on cryptocurrency regulation, which was banned by the central bank through its banking ban in 2018 but later nullified by the Internet and Mobile Association of India v. RBI (2020) 10 SCC 274, demonstrates how regulatory uncertainty hampers business altogether.

In a similar vein, fintech companies have to comply with either RBI guidelines or SEBI regulations, based on whether the services offered by them fall under lending, payment or securities services. This absence of proper classification results in something called 'regulatory arbitrage', wherein firms structure themselves around regulatory gaps to operate more easily, albeit in a legally dubious way.

Another problem which is not talked about as much is the angel tax under section 56(2)(viib) of the Income Tax Act, 1961. Even though there are exemptions in place for DPIIT recognized startups, the processes involved in seeking these exemptions and valuation of shares continues to be a deterrent for investments.

Compliance Gaps: Law in Letter vs. Practice

Although there have been some efforts made by India towards simplification of compliance via platforms such as MCA21 and GSTN, there still exist some compliance gaps. Firstly, there is uncertainty related to the law of labour compliance, particularly, in relation to the Code on Social Security, 2020, faced by gig-based startups who use the services of contract or freelance workers. There is no clarity in the classification of gig workers resulting in some legal and ethical challenges.

The other compliance gap is connected with data protection. With the recent adoption of the Digital Personal Data Protection Act, 2023, startups will need to comply with new obligations concerning consent, data storage and reporting of any breaches. However, due to their financial constraints, startups often fail to adopt the proper data governance policies.

Moreover, even though patent legislation in India provides an accelerated examination process for startups, IP protection in general remains underused because of the costs and lengthy procedure involved in enforcing the rights.

Unique Challenges: Innovation against Regulation

Another unexplored angle in the debate is that of culture difference between regulators and start-ups. Law tends to be structured in a manner which makes regulation of traditional businesses relatively easier owing to stability and risk-averse nature. But start-ups depend on fast iterations and taking risks. The result is what can be referred to as “temporal misalignment” where law evolves slowly but technology brings disruption quickly.

For instance, the concept of platform-based business models (like aggregators) has raised questions on employment, taxes and liability. Evolving law on intermediary liability by the Supreme Court (see Shreya Singhal v. Union of India, (2015) 5 SCC 1) is an example of attempt to find a middle ground between innovation and accountability but lacks applicability to new platforms.

Yet another aspect which is often neglected is the fatigue from regulations. Entrepreneurs tend to invest too much time on complying with laws and less on innovation especially during the scaling period where various legal requirements coincide at one point.

Bridging the Gap: The Path Ahead

Meeting the above-listed challenges will require measures beyond piecemeal reforms. Firstly, India may want to consider drafting an overarching “Startup Code,” which will include the essential elements of regulatory law while providing industry-specific clarity. Secondly, regulatory sandboxes which are already applied by the RBI and SEBI need to be implemented in other sectors allowing experimentation without compliance obligations.

Finally, proportionate compliance the level of obligations depending on the stage and risk level of the startup is essential. Startups at their early stages should not face the same level of regulatory burden as established firms. Conclusion In sum, Indian law in relation to startups presents both opportunities and challenges. Though various measures undertaken by policymakers have opened up new opportunities for entrepreneurs, regulatory burdens remain. In the future, it will be critical for Indian law to adjust rapidly, systematically, and empathically to the changing landscape of entrepreneurial law.

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