Regulatory Hotline

October 24, 2018

REGULATORY CONUNDRUM FOR START-UPS IN INDIA

While Indian companies were reeling under the pressure of a declining graph of fresh investments, Walmart announced the acquisition of 77% stake in Flipkart for $16 million in May 2018. As expected, it led to much fanfare and excitement as to what the investment could mean for the future of the promoters of the two ventures as well as the investors on both sides. While on one hand, there was some assurance to the Indian promoters that the international conglomerates were willing to walk the talk with respect to their investment in India, early stage investors in India learnt that there was money to be made in the Indian market.

The Walmart-Flipkart deal, apart from validating the Indian internet economy space, has brought into limelight the highs, lows and the positives and adversities that surround the start-up eco-system in India.

The last 6-7 years have been eventful for early stage companies and investors in India, with the ever-changing landscape, in terms of the shifting dynamics and inter-play between government policy, investor sentiment, and start-up culture. This article goes on to analyse the hits and misses with respect to policy, mindset of the regulators and the overall regulatory atmosphere for start-ups in the country.

GOVERNMENT AND POLICY

It is noteworthy that while several countries have undertaken measures to facilitate the growth of start-ups, India is one of the few countries to have a dedicated policy on start-ups. The 'Startup India' initiative of the Government of India, launched in January 2016, was touted to provide a kick-start to early stage companies by relaxing certain compliances for such companies. Under this initiative, an Indian entity not older than 7 years and fulfilling certain conditions with respect to turnover is entitled to certain benefits, like self-certification with respect to compliance with a few environmental and labour laws, access to certain funds from the Government of India, income tax exemption for 3 years in a block of 7 years (if incorporated after April 1, 2016), exemption from capital gains tax for 3 years, etc.

While the proposals set out in the Startup India initiative appeared to have been well directed towards providing the much-needed leeway from the cumbersome tax and legal compliances for a start-up, the initiative failed to achieve the desired potential. If statistics[1] were to be believed, merely 6,096 companies have been recognized as 'start-ups' by the Department of Industrial Policy and Promotion (DIPP), which is a bit lopsided considering the number of start-ups that are incorporated in India on an annual basis.

As an example, out of the 6,096, only 74 start-ups ended up receiving approval for availing tax benefits under the Startup India initiative, reason being that even though the DIPP has come up with requisite eligibility criteria, there is discretion in the hands of the inter-ministerial board which has been constituted for the purpose of approving / rejecting the grant of tax exemptions to start-ups. Though availing tax benefits may not be the end goal for many of the start-ups, the numbers indicate that there is a missing link, which is going unaddressed. Drawing a corollary with Singapore – Asia's start-up hub, where the regulations are crystal clear in terms of allowing tax exemptions - as long as the start-up is a tax resident of Singapore and the number of shareholders do not exceed 20 in a given assessment year, the tax exemption is applicable to it, for the first 3 years. Safe to conclude that simplicity in regulation and lack of regulatory discretion not only works as an incentive for start-ups, but also ensures wider applicability and acceptability amongst the players.

Certainly, the wheels of the government machinery have not kept pace with the evolving business models when it comes to policy making. However, increasing collaboration between the government and stakeholders and inclination of the government to increase stakeholder participation in policy making are some of the right steps in the direction, taken with all the right intent.

REGULATORY ASPECTS AND MINDSET OF REGULATORS

With the intent of increasing avenues for capital raise for Indian promoters, the Government of India *inter-alia* liberalized the sought-after sectors such as single-brand retail trading, e-commerce and regulated financial services and permitted issuance of convertible notes to foreign investors in start-ups. These measures contributed to infusion of more foreign capital into Indian companies in the last few years.

As per the Doing Business Report of 2018[2], India ranks 100 amongst 190 countries surveyed for the report, in terms of ease of doing business. This of course is a huge leap for India, from being at 130 in the previous year's report and it well establishes the fact that India has made some progress (if not significant) in making business conduct easier in India.

Having said that, one cannot deny that there is enough room for improvement here. Like it or not, the laws in India are partially to be blamed for this. The laws relating to business are still far away from the expected level of

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transparency, leading to ambiguous interpretation and difficulty in compliance. As a result, it has become cumbersome for entrepreneurs to strike a balance between achieving commercial success and ensuring compliance with laws.

Let's look at some of the regulatory conundrums plaguing the start-up ecosystem.

1. **Angel Tax**: If we analyse the Indian start-up funding space, angel funding plays a significant role in terms of lending credibility to start-ups and helping them reach a stage where they can confidently scout for Series A capital. As a tacit principle of the start-up world, funds brought in by the angels and venture capital funds, are more likely than not, at a premium to the fair market value of the shares of the company.

   Incidentally, as per the income tax laws of India, where a company receives any money as consideration for shares from a resident in excess of the fair market value, the company is liable to pay tax on the difference. This severely restricts Indian start-ups from issuing shares at a premium on the fair market value. The Government of India provided an exemption from such tax liability to start-ups incorporated before 2016. Any further exemption on this tax shall be subject to the approval of an inter-ministerial board subject to fulfillment of certain criteria including but not limited to paid up capital, net worth of the investor, etc. However, even if a start-up fulfills the criteria, the inter-ministerial board will have discretion to grant or deny the exemption.

2. **Cost of Compliance**: Speaking of cost for compliance, complying with existing laws and continuous education for employees on change in laws, comes at a cost. Some of the most common ones being, cost of incorporation, filings under various corporate laws, obtaining a valuation report under foreign exchange laws, compliances under state and central labour laws.

   Some of the compliances are burdensome, not merely from a cost perspective, but also in terms of the time consumed. For instance, one of the conditions imposed by the foreign direct investment policy on an e-commerce company is to ensure that not more than 25% of the sales on its platform are effected from one vendor or their group companies. Another instance is of peer-to-peer lending regulations issued by the Reserve Bank of India, which require peer-to-peer lending platforms to register as a non-banking financial company (NBFC) and comply with the obligations of an NBFC. These requirements seem onerous considering that e-commerce companies and peer-to-peer lending platforms are primarily technology driven companies and ensuring compliance with such conditions are not in consonance with the business being carried on by such entities.

3. **Choice of Offshore Jurisdiction**: Burdensome compliances, restrictions imposed under the foreign exchange laws and taxes payable at the time of providing exit to investors, better corporate tax rates in other countries, are some of the compelling reasons for Indian promoters to look for incorporation of their start-ups in offshore jurisdictions like Singapore, United States of America and other countries.

As discussed above, new business models bring along with them several new challenges. However, these challenges are not uncommon in countries like India that have a vibrant and diverse start-up culture, which is becoming mainstream in many ways, be it facilitating job creation, creating and developing products for consumers worldwide. India is an emerging and one of the most important markets for global players considering the population with disposable income and the growth in innovation and hence, it seems to be the need of the hour to ensure that the regulations nurture and promote technological innovations and growth of businesses in India. The good news is, the heart of the policy makers seems to be at the right place coupled with the right sense of urgency – so, all we need to watch out for is positive outcomes. After all, a synergy between regulations, favourable culture of innovation and infusion of capital is all that is needed to ensure continued traction in the entrepreneurial atmosphere.

– Saumya Ramakrishnan & Harshita Srivastava
You can direct your queries or comments to the authors

[1] Startup India status report dated January 4, 2018
[2] Doing Business 2018: Reforming to Create Jobs published on October 31, 2017 by the World Bank

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