

The background of the journal cover features a top-down view of a desk. On the left, a pair of black leather brogue shoes is partially visible. In the center, an open notebook with lined pages and a silver pen lies on a light-colored wooden surface. To the right, a black leather bag with a zipper is partially shown, and a black leather watch with a silver dial is resting on the desk. A large, semi-transparent white rectangular box is centered over the image, containing the journal's title and ISSN information.

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# **REGULATION OF STARTUP INVESTMENT IN INDIA**

## **A Comprehensive Legal Analysis of the Evolving Framework**

AUTHROED BY - PROTIK GHOSH

Amity Law School

### **ABSTRACT**

*India has emerged as the world's third-largest startup ecosystem, with over 1.4 lakh DPIIT-recognised startups as of 2025. The rapid proliferation of venture capital, angel investment, and foreign direct investment into Indian startups has necessitated a multi-layered regulatory architecture that balances investor protection with entrepreneurial freedom. This article examines the principal statutes, regulations, and policy frameworks governing startup investment in India — including the Companies Act 2013, FEMA 1999, SEBI regulations, the Angel Tax provisions, and the Startup India initiative — while critically evaluating their impact on the investment landscape, compliance burdens, and recent reforms.*

**Keywords:** Startup Investment, FEMA, FDI Policy, Angel Tax, SEBI, Venture Capital, DPIIT, Companies Act

### **1. Introduction**

India's startup ecosystem has witnessed exponential growth over the past decade, attracting billions of dollars in domestic and foreign investment. From Bengaluru's technology corridors to Mumbai's fintech hubs and Delhi's agri-tech clusters, Indian startups have reshaped industries and generated millions of employment opportunities. This growth has been accompanied by an increasingly complex regulatory framework designed to govern how capital flows into early-stage and growth-stage enterprises.

Investment law in the context of Indian startups is not governed by a single statute; rather, it is an amalgamation of corporate law, foreign exchange law, securities regulation, tax law, and sector-specific rules. Understanding this regulatory mosaic is essential for founders, investors — both domestic and foreign — legal practitioners, and policymakers. This article provides a structured analysis of the key regulatory pillars shaping startup investment in India, tracing their evolution and assessing their effectiveness in creating a conducive investment climate.

## **2. The Companies Act, 2013: Foundational Corporate Framework**

The Companies Act, 2013 forms the bedrock of corporate regulation for Indian startups. Most venture-backed startups are incorporated as Private Limited Companies under this Act, which prescribes rules on share capital, equity issuance, shareholder agreements, and corporate governance.

### **2.1 Equity and Instrument Flexibility**

The Act permits companies to issue various classes of shares, including equity shares, preference shares, and compulsorily convertible debentures (CCDs) and compulsorily convertible preference shares (CCPS) — instruments widely used in startup financing rounds. These convertible instruments allow investors to hold debt-like security initially while retaining the right to convert into equity at a future valuation, balancing risk and reward.

### **2.2 Employee Stock Options (ESOPs)**

Section 62(1)(b) of the Companies Act enables private companies to offer Employee Stock Option Plans, which are a critical tool for talent retention in cash-strapped startups. The 2020 amendment liberalised ESOP taxation by deferring tax incidence to the point of sale rather than vesting, reducing the tax burden on employees — a reform widely welcomed by the startup community.

## **3. Foreign Exchange Management Act (FEMA), 1999 and FDI Policy**

Foreign Direct Investment (FDI) is among the most significant sources of startup capital in India. The regulatory framework for FDI is primarily governed by the Foreign Exchange Management Act, 1999, operationalised through the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, and India's Consolidated FDI Policy issued by the Department for Promotion of Industry and Internal Trade (DPIIT).

### **3.1 Automatic Route vs. Government Route**

For most startup sectors — including technology, e-commerce (B2B), and manufacturing — FDI is permitted under the automatic route, meaning no prior government approval is required. However, certain sensitive sectors such as defence, telecom, and multi-brand retail require government approval. Startups must carefully ascertain the applicable route to ensure compliance, as violations attract penal consequences under FEMA.

### **3.2 Pricing Guidelines and Valuation**

The FEMA framework mandates that equity shares issued to foreign investors must not be below the fair market value as determined by a SEBI-registered merchant banker or a chartered accountant using internationally accepted pricing methodologies such as the Discounted Cash Flow (DCF) method or Comparable Companies Analysis (CCA). This pricing discipline prevents undervalued transfer of equity and ensures genuine price discovery.

### **3.3 Downstream Investment Regulations**

Where a foreign-invested startup itself invests in another Indian entity (downstream investment), compliance with DPIIT's downstream investment guidelines is mandatory. The regulations require that downstream investments follow the same sectoral caps and conditions applicable to direct FDI, preventing regulatory arbitrage through multi-layered corporate structures.

## **4. SEBI Regulations: Venture Capital and Alternate Investment Funds**

The Securities and Exchange Board of India (SEBI) plays a pivotal role in regulating institutional investors that channel funds into startups, particularly through the Alternate Investment Funds (AIF) Regulations, 2012.

### **4.1 The AIF Framework**

AIFs are privately pooled investment vehicles that collect capital from sophisticated investors for investing in startups and other alternative assets. SEBI categorises AIFs into three categories: Category I AIFs (which include Venture Capital Funds and Angel Funds), Category II AIFs (Private Equity Funds), and Category III AIFs (Hedge Funds). Venture Capital Funds investing predominantly in unlisted startups fall under Category I, which benefits from certain regulatory concessions and tax pass-through treatment under the Income Tax Act.

### **4.2 Angel Funds**

Recognising the unique role of angel investors in early-stage startup financing, SEBI created a sub-category of Angel Funds under Category I AIFs. Angel Funds can raise capital from accredited angel investors with a minimum investment threshold and invest in startups with no more than ten years of operation. The 2021 amendment reduced the minimum corpus requirement and eased compliance, making the structured angel investment route more

accessible.

## **5. The Angel Tax Controversy and Section 56(2)(viib)**

Perhaps no regulatory provision has generated more controversy in India's startup ecosystem than the 'Angel Tax' under Section 56(2)(viib) of the Income Tax Act, 1961. Originally introduced in 2012 to curb money laundering, this provision taxed the premium received by a closely held company upon issuance of shares at a price exceeding fair market value as income from other sources — effectively penalising startups that raised capital at high valuations.

The provision caused significant distress to the startup community, as DPIIT-recognised startups — whose valuations are inherently speculative and future-oriented — found themselves receiving tax notices for legitimate fundraising. In 2019, the government exempted DPIIT-recognised startups from Angel Tax, subject to conditions including a cap on paid-up share capital and adherence to valuation norms. However, the 2023 Union Budget extended the provision to foreign investors, triggering fresh alarm. Subsequently, in 2024, the government announced the complete abolition of Angel Tax for all classes of investors, a landmark reform welcomed by investors and founders alike as a crucial step toward a more rational investment climate.

## **6. The Startup India Initiative and DPIIT Recognition**

Launched in January 2016, Startup India is the Government of India's flagship initiative to foster entrepreneurship and build a robust startup ecosystem. At the heart of this initiative is the DPIIT recognition framework, under which entities meeting specified criteria — including incorporation age of up to ten years, annual turnover not exceeding INR 100 crore, and pursuit of innovation or scalable business models — are eligible for recognition.

DPIIT recognition unlocks a bouquet of regulatory and fiscal benefits: tax exemption for three consecutive years under Section 80-IAC of the Income Tax Act, exemption from Angel Tax, self-certification under labour and environmental laws, fast-track patent examination, access to the Fund of Funds for Startups (FFS) managed by SIDBI, and government procurement preferences. This recognition framework has significantly lowered the regulatory compliance burden for eligible startups and incentivised formalisation of the startup ecosystem.

## **7. Recent Reforms and the Road Ahead**

India's regulatory framework for startup investment has undergone significant liberalisation in recent years. The decriminalisation of certain offences under the Companies Act, the introduction of the One Person Company concept, the National Startup Advisory Council, and the Drone, Space, and Geospatial liberalisation policies have expanded opportunities for deeptech startups to attract capital. SEBI's framework for accredited investors and its Social Stock Exchange initiative represent forward-looking efforts to broaden the capital market's interface with innovative enterprises.

Nonetheless, challenges persist. Regulatory fragmentation across multiple ministries and agencies creates compliance complexity. Ambiguities in the characterisation of instruments for FEMA and tax purposes continue to create uncertainty. The absence of a single, unified startup investment law remains a structural gap. As India aspires to become a global innovation hub, a coherent, investor-friendly, and predictable legal framework will be indispensable.

## **8. Conclusion**

The regulation of startup investment in India is a dynamic, evolving domain that sits at the intersection of corporate law, foreign exchange regulation, tax policy, and securities law. The legal framework has matured considerably since the early 2010s, with landmark reforms such as the abolition of Angel Tax, liberalised ESOP taxation, and the AIF framework transforming the investment landscape. The Startup India initiative has provided an institutional anchor for regulatory benefits.

For India to sustain its position as a leading startup destination, policymakers must continue harmonising regulations, reducing interpretive uncertainty, and engaging with the ecosystem on prospective reforms. Lawyers and investors operating in this space must maintain fluency across this multi-statute framework to structure compliant, efficient investment transactions that protect all stakeholders and fuel India's entrepreneurial ambitions.