



# The Indian Journal for Research in Law and Management

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## LEGAL FRAMEWORK FOR STARTUPS IN INDIA

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Startups<sup>1</sup> are innovative young companies established to develop unique products or services and introduce them to the market, making them essential and unparalleled for customers. These companies strive to address shortcomings in existing products or to invent completely new categories of goods and services, thereby challenging established industry norms and business practices. India's startup ecosystem is a dynamic and pivotal component of its economic growth, marked by an impressive surge in entrepreneurial ventures across diverse sectors. Major cities like Bangalore, Mumbai, and Delhi have emerged as startup hubs, attracting both domestic and international investors. These urban centers are complemented by a network of incubators, accelerators, and co-working spaces that foster innovation and collaboration among the entrepreneurial community.

Launching a new business venture is thrilling, yet it's crucial to carefully consider the legal aspects to establish a strong foundation for your startup. Navigating the legal landscape involves more than just complying with regulations; it is essential for securing funding, safeguarding intellectual property, and ensuring the long-term viability of the business. This article delves into the intricate legal framework that governs these startups, providing a roadmap for entrepreneurs to navigate the complexities of legal compliance.

### Choosing the right business structure

The first step for any startup in India involves registering its business entity. Selecting the appropriate legal structure for one's startup is crucial, as it determines the level of personal liability,

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<sup>1</sup> Rebecca Baldridge, Benjamin Curry, WHAT IS A STARTUP? THE ULTIMATE GUIDE, Forbes (30th May 2024, 7:00PM), <https://www.forbes.com/advisor/in/investing/what-is-a-startup/>.

tax obligations, and governance requirements. These business structures should be chosen based on the following criteria:

- Number of Owners.
- Level of liability and personal risk.
- Control over business decisions and ownership.
- Ability to raise or borrow money/Credibility.
- Registration and maintenance costs.
- Procedural requirements under law.
- Continuity of existence.
- Taxation Structure.
- Privacy of documents.

Some of the common options after considering these factors are:<sup>2</sup>

- A) Sole Proprietorship:** A Sole Proprietorship is a business structure where a single individual owns, manages, and controls all aspects of the business. This form of business organization is straightforward and one of the simplest entities to establish, making it a popular choice for many entrepreneurs.
- B) Partnership:** It is a business structure where two or more individuals come together to operate a business with the mutual objective of earning a profit. This form of business organization is governed primarily by the Indian Partnership Act, 1932. It is a flexible and commonly used structure in India, particularly suited to small and medium-sized enterprises.
- C) Limited Liability Partnership (LLP):** It is a modern business structure in India, established under the Limited Liability Partnership Act of 2008. It is a hybrid model that merges characteristics of both traditional partnerships and corporations, offering limited liability to its partners. This structure provides flexibility in management, favorable taxation compared to a conventional company and no requirement for a minimum capital contribution, making it an attractive option for many entrepreneurs and professional services.

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<sup>2</sup> Arohana Legal, <https://arohanalegal.com/startups/legal-checklist-for-startups-india/>, (30<sup>th</sup> May 2024, 7:00PM).

**D) Private Limited Company:** A business structure governed by the Companies Act, 2013, favored for its limited liability feature. In this setup, the owners are referred to as shareholders, and their liability is restricted to the unpaid amount on their shares. This company structure mandates a minimum of two directors and allows for up to 200 shareholders. It offers benefits such as permanency in existence, ease of raising capital through equity, and a more credible image, which can be advantageous in dealings with vendors and lenders.

Each structure comes with its own set of advantages and disadvantages. It is important for the startup founders to consult a legal professional to choose the best structure as per their needs.

### **Registering the business:**

Registering a startup as a legal entity is crucial for protecting its intellectual property assets, securing a legal business name, and establishing credibility with clients and investors. The registration process generally requires submitting the appropriate documents to relevant government authorities, such as the Registrar of Companies for LLPs and Private Limited Companies. Additionally, it involves obtaining necessary business licenses or permits such as:<sup>3</sup>

- GST Registration.
- Trade License for commercial establishments like shops, restaurants etc.
- Businesses that have an impact on the environment require a license from the Pollution Control Board.
- The Food Safety and Standards Authority issues FSSAI licenses to food businesses.
- 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).

The specific licenses or permits a startup needs depend on the nature of its business.

### **Intellectual property Rights**

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<sup>3</sup>كAnsuman Biswal, LEGAL CONSIDERATIONS FOR STARTING A STARTUP IN INDIA, LinkedIn (30<sup>th</sup> May 2024, 8:00PM),ك <https://www.linkedin.com/pulse/legal-considerations-starting-successful-startup-india-ansuman-biswal-hwk9c/>.

Intellectual<sup>4</sup> Property Rights<sup>5</sup> (IPR) are essential for startups in India, protecting their innovations and creative works. This safeguard not only secures a startup's valuable assets—such as technology, brand names, and unique designs—but also enhances its competitive edge. A robust IP portfolio can deter competitors from copying or infringing on proprietary content, attract investors, and significantly increase the company's valuation during funding rounds. Effective management of IP is, therefore, crucial for fostering innovation and ensuring business growth.

### A) Types of Intellectual Property:

Startups need to familiarize themselves with different types of IP:

- **Patents:** Protect innovations and inventions, providing exclusivity to use, manufacture, and sell the patented invention for a specific period.
- **Trademarks:** It protects a name, design, symbol, phrase, logo, image, or a combination of these elements. They play an essential role in building a brand identity and ensuring that customers associate certain qualities with the startup's products or services.
- **Copyrights:** Protect literary, artistic, musical, and film works from being copied without permission. For content creators and software companies, copyrights are a fundamental component of their business models.
- **Designs:** Protect the appearance or aesthetics of a product, which can be important for consumer goods where design differentiates products in the marketplace.

### B) Registering and Managing IP:

In India, IP registration for startups is managed by specific government agencies: the Indian Patent Office handles patents and designs, while trademarks are registered through the Registrar of Trademarks. Copyrights are automatically protected upon creation and do not require registration.

Additionally, recognized startups can benefit from the Startups Intellectual Property Protection (SIPP) scheme, which offers an 80% reduction in patent registration fees and a 50% reduction in

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<sup>4</sup>Id.

<sup>5</sup>Quadrant Technologies, SAFEGUARDING INNOVATION: THE CRUCIAL ROLE OF INTELLECTUAL PROPERTY PROTECTION FOR INDIAN STARTUPS (PART 1: UNDERSTANDING INTELLECTUAL PROPERTY AND IT), LinkedIn (30<sup>th</sup> May 2024, 8:00PM), <https://www.linkedin.com/pulse/safeguarding-innovation-crucial-role-intellectual-k0tge/>.

trademark registration fees. To maximize protection, startups should consider professional guidance from IP attorneys to ensure accurate application preparation and submission.

## **Contracts and Agreements:**

Drafting and negotiating contracts and agreements form a crucial aspect of a startup's legal framework, ultimately aiding in its growth and success. Essential agreements may encompass:

- **Employee contracts** – These outline specific employment terms, including conditions of service, compensation and benefits, termination, notice periods, and confidentiality agreements.
- **Terms of Service (ToS) or User Agreements** – These are legal agreements between a service provider (like a website or app) and its users, detailing the terms and conditions users must follow when using the service or platform.
- **Vendor contracts** – These contracts specify the terms under which goods or services are purchased or sold, covering aspects such as the nature, quantity, delivery timeframe, and quality of goods/services, along with pricing, payment terms, indemnification, liability, and provisions for Force Majeure.
- **Non-disclosure agreements (NDAs)** – NDAs are legal contracts that govern the sharing of confidential information between parties, ensuring that the recipient agrees to keep the information secret. They are commonly used to protect sensitive data, trade secrets, and proprietary business details.
- **Partnership or Shareholder agreements** – These documents define the business relationship terms, including roles and responsibilities, shareholding patterns, profit-sharing structures, and conditions for termination.

Ensuring that these contracts protect the startup's interests, mitigate risks, and comply with applicable laws and regulations is essential.

## **Labor Laws and Compliance:**

Compliance with labor laws is essential for startups in India to ensure fair and legal treatment of employees and to avoid legal repercussions that could derail the business. Understanding and adhering to these regulations is crucial as startups scale and expand their workforce.

### **A) Fundamental Labor Laws:**

Startups need to be familiar with several key pieces of legislation that govern employment in India. These include:

- **The Industrial Disputes Act:** Governs the resolution of industrial disputes, provides for the rights of workers, and outlines the procedures for layoffs, retrenchments, and closures.
- **The Shops and Establishments Act:** Applicable to all commercial establishments, dictating rules on work hours, rest intervals, overtime, holidays, and other work conditions.
- **The Minimum Wages Act:** Ensures that all workers are paid at least the minimum wage. Compliance with this law is critical to avoid penalties and improve employee satisfaction.

### **B) Compliance Requirements:**

Ensuring compliance involves several practical steps which include:

- Employee Contracts.
- Social Security Contributions.
- Workplace Safety and Health.

However, 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.

### **C) Non-compliance Consequences:**

Failure to comply can result in fines, legal conflicts, and damage to reputation. It can also harm employee morale and retention. Therefore, startups should prioritize legal counsel and effective human resource management to fulfill legal obligations and foster a supportive workplace culture.

### **Tax Compliance:**

Tax compliance is essential for startups in India, particularly once their turnover exceeds the government-specified thresholds: Rs. 40 lakhs for most of the country and Rs. 20 lakhs for businesses in northeastern states. Registering for Goods and Services Tax (GST) is mandatory for these startups, as GST integrates various indirect taxes and is crucial for companies conducting

interstate commerce. Understanding direct tax obligations, such as income tax and corporate tax, is also crucial for startups.

The government provides several tax incentives under the Startup India initiative for recognized startups, including:<sup>6</sup>

- A three-year tax holiday for startups registered or incorporated between April 1, 2016, and March 31, 2022.
- Exemptions on investments above fair market value.
- The ability to set off carry forward losses as permitted under Section 79 of the Income Tax Act.
- Exemption on Long-term Capital Gains.
- Tax exemption under Section 54GB of the Income Tax Act.

However, to qualify for these benefits and ensure compliance, startups must meet specific criteria:

- The company should be less than ten years old from the date of incorporation or registration.
- It must be registered as a partnership firm, limited liability partnership, or private limited company.
- Its annual turnover in any fiscal year must not exceed Rs. 100 crores.
- The startup must be actively engaged in developing and innovating new products and services.
- The company must not be formed from the reconstruction or splitting up of an existing business.

Maintaining rigorous tax compliance is vital due to legal, economic, and reputational factors. This includes keeping accurate and up-to-date books of accounts, ensuring proper documentation of transactions, invoices, receipts, and vouchers, and fulfilling statutory deductions like Provident Fund (PF) and Employees' State Insurance (ESI). Failure to comply can adversely affect a startup's

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<sup>6</sup>Tata AIA, <https://www.tataaia.com/blogs/life-insurance/complete-tax-guide-for-startups-in-india.html>, (31<sup>st</sup> may 2024).

financial health. Moreover, strategically leveraging tax incentives, exemptions, and deductions is crucial for optimizing financial performance.

## **Funding and Financial Regulations:**

Startups need capital for growth, and a clear understanding of the regulatory framework governing funding can streamline the process and ensure legal compliance.

### **A) Funding Avenues for Startups:<sup>7</sup>**

Startups in India have access to a variety of funding sources:

- **Bootstrapping (Self-Financing):** This approach involves using personal savings to fund the startup, offering complete control to the founders but potentially limiting growth in scale and pace.
- **Startup Incubators and Accelerators:** These programs provide mentorship, resources, and networking opportunities, often taking equity in exchange for support to encourage rapid development.
- **Venture Capital (VC) and Angel Investors:** These investors offer capital in exchange for equity and often provide mentorship and access to their business networks.
- **Bank Loans:** Indian banks offer traditional loans and working capital loans to startups based on their creditworthiness and business plans.
- **Government Grants and Schemes:** Under initiatives like Startup India, startups can avail financial aids and incentives, including grants, seed funding, and bank loan guarantees.
- **Crowdfunding:** Platforms such as Kickstarter, Fuel A Dream, and Indiegogo enable startups to collect small contributions from a large number of people, often as part of a product pre-sale.

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<sup>7</sup> India Filing, <https://www.indiafilings.com/learn/how-to-raise-funds-for-startups-in-india/#:~:text=Banks%20in%20India%20provide%20traditional,entrepreneurs%20to%20retain%20full%20ownership> ip. (31st May 2024).

For startups in India looking to raise funds, it is essential to understand and comply with the requirements outlined in the Companies Act, 2013. Here's an overview of key funding compliance stages:<sup>8</sup>

### **I. Pre-Funding Compliance:**

Startups seeking to raise funds need to navigate two primary methods: private placement and rights issues. Private placement involves issuing securities directly to selected investors, circumventing a public offering, while a rights issue allows existing shareholders to purchase additional shares to inject more capital into the company. The pre-funding compliance steps include:

- Increasing authorized share capital
- Conducting a Board meeting
- Holding an Extraordinary General Meeting (EGM)
- On getting the approval, the private placement offer letter cum application is to be given to the proposed investors/ allottees within 30 days, in writing or through electronic mode.

### **II. Post-Funding Compliance:**

After securing investment, certain compliances must be met:

- Shares must be allotted to investors within 60 days of receiving the funds through private placement.
- Share certificates should be issued to investors as proof of ownership.

### **B) Financial Regulations and Compliance:**

Understanding and adhering to financial regulations is essential to ensure legal compliance:<sup>9</sup>

- **Securities and Exchange Board of India (SEBI) Regulations:** Compliance with SEBI guidelines is essential for startups engaging in public funding or venture capital, as SEBI regulates securities markets and venture funds.

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<sup>8</sup>CS Neha Maheshwari, Navigating Fundraising Compliances for Start-ups in India, LinkedIn (31st May 2024, 5:00PM), <https://www.linkedin.com/pulse/navigating-fundraising-compliances-start-ups-india-cs-neha-maheshwari/>.

<sup>9</sup>SRK & Associates, STARTUP INVESTMENTS IN INDIA: A LEGAL, REGULATORY AND COMPLIANCE PERSPECTIVE & ROLE OF A COMPANY SECRETARY, LinkedIn (31<sup>st</sup> May 2024, 4:00PM), <https://www.linkedin.com/pulse/startup-investments-india-legal-regulatory-compliance/>.

- **Foreign Direct Investment (FDI) Policies:** Startups receiving foreign investments need to adhere to FDI policies, which dictate the allowable percentage of foreign ownership, sectors eligible for investment, and the necessary approval processes.

Overall, a deep understanding of these funding mechanisms and rigorous adherence to financial regulations are vital for the sustainable growth and credibility of startups in India.

## **Challenges and Legal Disputes:**

Navigating the complex legal landscape presents several challenges for startups in India, often leading to legal disputes if not managed carefully. Awareness and proactive management of potential legal issues are crucial for maintaining smooth operations and safeguarding the business.

### **A) Common Legal Challenges:**

Startups frequently encounter challenges such as:

- Intellectual Property Disputes
- Contractual Disputes
- Non-compliance with Regulatory laws and regulations.

### **B) Dispute Resolution Mechanisms:**

To address disputes, startups can consider several mechanisms:

- **Alternative dispute resolution (ADR):** These alternative dispute resolution methods as governed by The Arbitration and Conciliation Act, 1996 can be cost-effective and less time-consuming compared to litigation, and they offer confidentiality. Options available under ADR are:
  - I. Arbitration:** It involves a neutral third party, known as an arbitrator, who listens to the arguments and evidence from both sides and then makes a decision. This decision, often binding, is called an award. Arbitration is less formal than a court proceeding but follows a procedural framework similar to a trial, including the presentation of evidence and the making of arguments.
  - II. Mediation:** Mediation is a facilitated negotiation process where a neutral mediator assists disputing parties in reaching a mutually agreeable solution. Unlike arbitration, the mediator doesn't make decisions; instead, they facilitate effective

communication and exploration of solutions, fostering a collaborative resolution. Mediation is voluntary, confidential, and aimed at preserving relationships between the parties.

**III. Conciliation:** Conciliation is similar to mediation in that it involves a conciliator who assists the parties in reaching a settlement. However, the conciliator typically plays a more active role by suggesting terms of settlement and may meet with the parties separately to help them reconcile their differences. Like mediation, conciliation is voluntary, non-binding, and aimed at finding a mutually agreeable solution to the dispute.

- **Litigation:** Sometimes unavoidable, litigation should be considered when other resolution methods fail. However, it is important to assess the potential impact on resources and business reputation.

Understanding and preparing for these challenges through strategic legal planning and expert advice can significantly mitigate risks and aid in the stable growth of a startup.

## **Conclusion:**

In conclusion, successfully navigating the legal complexities of launching and operating a business in India is essential for every startup. The journey begins with selecting the right business structure, which significantly impacts financial liability and tax obligations. Equally crucial is the protection of intellectual property, which fosters innovation and secures the startup's unique assets against competition. Strict adherence to financial and labor regulations not only enhances a startup's reputation but also stabilizes its operations, thereby attracting investors and skilled employees. Additionally, understanding and engaging with various funding mechanisms without compromising legal integrity is vital for sustainable growth. Each stage, from choosing the appropriate business entity to dealing with the legal system for dispute resolution, requires meticulous legal consideration and proactive management. This highlights the critical importance of sound legal advice in ensuring the success of startups within India's dynamic economic landscape.