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LEGAL IMPLICATIONS OF EMERGING TECHNOLOGIES; ASSESSING THE IMPACT OF INTERSECTION OF TAXATION LAWS AND FIN-TECH STARTUPS IN INDIA

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Abstract

With the swift expansion of FinTech startups and digital banking services in India, these sectors are significantly transforming the financial landscape by employing cutting-edge technologies such as peer-to-peer lending, blockchain, and online payment systems. The adoption of these innovative technologies is challenging conventional financial models, thereby necessitating a re-evaluation and evolution of existing taxation frameworks to effectively accommodate these new business paradigms. As emerging technologies increasingly blur the lines between traditional and modern financial structures, it becomes imperative that tax laws are restructured to address the unique issues that arise within these new models of operation.¹ The research paper highlights the need to adapt the legal principles surrounding taxation in response to the rapid development of technology-driven financial services with respect to certain questions that arise herein. How effective are current tax laws in fostering innovation in India's FinTech sector? Are frequent changes in tax laws creating barriers to the growth of FinTech companies, or do they facilitate better governance? What are the key legal and tax-related challenges faced by FinTech startups operating across multiple jurisdictions? How does the dynamic regulatory environment affect the compliance efforts of FinTech startups in India? How to deal with these problems? All these questions shall be addressed by the end of this research.

Keywords: Fin -tech, laws, effectiveness, dynamic, challenges, multiple jurisdictions etc.

¹ Key Challenges of Fin-Tech, Score Me, <https://scoreme.in/challenges-of-fintech>, Last Accessed on 6th October 2024.

Introduction; The Evolving Dynamics of Fin-Tech

Globally, the FinTech sector has continued to gain significant traction. The industry has been continuously expanding as a result of rising consumer demand as well as the introduction of cutting-edge business models and technologies to make processes and services streamlined, economical, and customer-centric. With the third-largest FinTech market in the world right now, India is expected to develop faster than the rest of the world between now and 2025, with a compound annual growth rate (CAGR) of 31%. In 2021, 2.3 FinTech companies in India raised \$10.6 billion in investment. Four FinTech start-ups have demonstrated more maturity by deciding to pursue strategic mergers and acquisitions (M&A) to accelerate inorganic growth in addition to submitting applications for initial public offerings.²

The demand for professionals with a FinTech concentration in India has increased as a result of this expansion. However, high hiring costs and attrition as a result of growing rivalry among start-ups provide two significant employment issues for FinTech companies. This problem for the FinTech sector might be solved by platforms designed to improve the abilities of recent graduates. In order to support the Indian FinTech ecosystem, the Unique Identification Authority of India (UIDAI) introduced new infrastructure in 2009. This covered services and products using open application programming interfaces (APIs), such the Unified Payments Interface (UPI). Public infrastructure includes Aadhar, e-KYC, e-Sign, the Bharat Bill Payment System (BBPS), and Digi-Locker. The demand for professionals with a FinTech concentration in India has increased as a result of this expansion. However, high hiring costs and attrition as a result of growing rivalry among start-ups provide two significant employment issues for FinTech companies. Platforms created for both government agencies and private companies can make use of this digital infrastructure to empower customers and innovate business practices. Several different frameworks have contributed to the growth of the FinTech industry. The establishment of the Open Credit Enablement Network (OCEN) marked a significant advancement in promoting financial inclusion throughout the nation. OCEN has the potential to facilitate communication among lenders, borrowers, technology service providers (TSPs), and other stakeholders in the lending value chain by serving as a common language.³

² Tax Incentives, Tax Guru, <https://taxguru.in/income-tax/tax-incentives-fintech-sector.html>, Last Accessed on 7th October 2024.

³ Changing Face of Financial Services, PWC, <https://www.pwc.in/assets/pdfs/consulting/financial-services/fintech/publications/the-changing-face-of-financial-services-growth-of-fintech-in-india-v2.pdf>, Last Accessed on 8th October, 2024.

The development of new payment systems may benefit from the 2020 release of the New Umbrella Entities (NUE) framework, which aims to improve retail payment services (RPS). Some of the potential future rails that could alter the Indian FinTech environment are the Central Bank Digital Currency (CBDC) project, which wants to govern the cryptocurrency market, and the Open Network for Digital Commerce (ONDC), which intends to democratize digital commerce.⁴

In the Union Budget 2022, the Government of India (GoI) suggested creating 75 digital banking units (DBUs). The Reserve Bank of India's (RBI) circular outlining requirements for establishing DBUs bolstered this as well. These DBUs have the necessary digital infrastructure to offer banking services and would serve as business points or hubs.⁵ They would also be able to manage the self-service servicing needs for a larger customer base.

There is currently no single set of regulations governing all fintech services in India, and instead, the legal framework for fintech is fragmented. The lack of a comprehensive set of fintech regulations makes it difficult to adequately regulate the industry given its dispersion. The Reserve Bank of India (RBI), the Insurance Regulatory and Development Authority of India (IRDAI), the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), and the Ministry of Electronics and Information Technology (MEITY) are the main regulatory bodies in India that keep an eye on this industry.

Testing the Waters; Effectiveness of Laws and Schemes on Taxing Fin-Tech Startups

Some of the laws, schemes and exemptions are as follows: -

- **Section 80-IAC of the Income Tax Act:** Provides eligible startups with a tax exemption for three consecutive years, encouraging innovation in digital financial services.
- **Payment and Settlement Systems Act, 2007:** The RBI is tasked with overseeing and regulating "payment systems" in India. A "payment system" is defined by the PSS Act as a system that makes it easier for a payer to transfer money to a beneficiary through facilitation. Services for clearing, paying, or settling, or any combination of these, are

⁴ Supra Note 3.

⁵ Digital Banking Units, Indian Express, <https://indianexpress.com/article/explained/everyday-explainers/what-are-digital-banking-units-7878178/>, Last Visited on 8th October 2024.

provided by this system. But it makes it clear that stock exchanges are not included in its definition.

- **Angel Tax Exemption:** It is for the FinTech startups raising capital, relaxations on "angel tax" rules for investments from domestic and foreign investors support growth in this high-tech sector.
- **Startup India Initiative:** Offering tax holidays, capital gains exemptions, and rebates on income tax to recognized startups, which include many FinTech companies.
- **Exemption from taxes for individuals and HUF when investing long-term capital gains in equity shares of qualified startups under Section 54GB:** If long-term capital gains from the sale of a residential property are invested in small or medium-sized businesses as defined by the Micro, Small and Medium Enterprises Act of 2006, then the current provisions under Section 54GB permit the exemption from tax on such earnings. However, as of right present, this part has been changed to also exempt capital gains made investments in qualified startups. Therefore, tax on long-term capital will be waived if a person or HUF sells a residential property and uses the capital gains to purchase 50% or more of the equity shares of qualified startups, provided that the shares are not transferred or sold within five years of the date of acquisition. Additionally, the startups must use the invested funds to buy assets, and they are not permitted to transfer those assets within five years after the date of purchase. This exemption will encourage the growth and expansion of qualifying startups by increasing investment in them.
- **Other Significant Legislations:**
 - a) The National Payments Corporation of India (NPCI) Regulations
 - b) The Companies Act, 2013
 - c) Regulations/ guidelines by the SEBI
 - d) The Insurance Web Aggregator Regulations, 2017
 - e) PPI (Prepaid Payment Instruments) and PAPG (Payment Aggregators and Payment Gateways) Guidelines by RBI.⁶

The challenges experienced in the implementation of these schemes, laws and exemptions are:-

- Complexity in Multi-Jurisdictional Operations: FinTech startups frequently engage with clients on a global scale or operate in multiple jurisdictions, creating complex tax

⁶ Fintech India, KPMG, <https://assets.kpmg.com/content/dam/kpmg/pdf/2016/06/FinTech-new.pdf>, Last Accessed on 9th October 2024.

scenarios. For instance, a startup headquartered in India with subsidiaries or partnerships in other countries faces challenges in determining where taxes should be paid—whether based on residency or source-based taxation. These complications arise from the overlap of tax regulations across jurisdictions. Startups must navigate transfer pricing regulations, adhere to tax treaties, and manage Permanent Establishment (PE) concerns. To ensure compliance with both domestic and international tax laws, they often require sophisticated strategies tailored to their specific operational structures.

- Cross-Border Transactions: FinTech companies routinely engage in cross-border transactions involving payments, remittances, or investments. These activities give rise to various tax obligations, including withholding taxes, GST on the import/export of services, and VAT in foreign regions. Startups must comply with the distinct tax requirements of each country they operate in, adding significant complexity to their tax compliance efforts. Additionally, the rise of digital service taxes (DSTs) in many jurisdictions introduces further complications, particularly for businesses dealing with digital financial services.
- Ambiguity in Tax Treatment of Digital Assets: FinTech startups, which frequently handle emerging technologies such as blockchain, cryptocurrencies, and digital wallets, are subject to unclear and evolving regulatory frameworks. The taxation of digital assets remains a grey area, with uncertainty surrounding whether profits from cryptocurrency transactions should be classified as capital gains or business income. Inconsistent guidelines from tax authorities increase the risk of non-compliance, exposing startups to penalties, litigation, or tax disputes.
- Navigating the Angel Tax Exemption: While the Angel Tax Exemption provides much-needed relief to startups by easing restrictions on investments from angel investors, the issue of valuation remains a critical challenge. The tax authorities often scrutinize the fair market value of shares issued by startups, particularly those with high valuations but relatively low revenues. Discrepancies in valuations between investors and the tax department can lead to lengthy legal disputes or additional tax assessments. Furthermore, foreign investments introduce complications related to the Foreign Exchange Management Act (FEMA), further complicating compliance.⁷

⁷ Simplified Tax Structure, Business Standard, https://www.business-standard.com/economy/news/fintech-budget-wishlist-simplified-tax-structures-regulatory-clarity-124071700630_1.html, Last Accessed on 9th October 2024.

- **Constantly Changing Regulatory Environment:** The dynamic nature of tax regulations presents an ongoing challenge for FinTech startups. Government frequently amends tax rules to keep pace with developments in the digital economy, which can create confusion regarding deadlines, reporting obligations, and applicable tax rates. To remain compliant, startups must invest in a robust tax infrastructure or seek expert legal and tax advice. Failure to do so risks inadvertent non-compliance, with potential financial or legal repercussions.
- **Difficulties in Availing Incentives:** While tax incentives are available to startups, the process of accessing them is often hampered by bureaucratic hurdles. FinTech startups, in particular, may struggle with eligibility criteria, documentation requirements, and verification processes for tax incentives such as Section 80-IAC or Angel Tax exemptions. These procedural complexities can delay the benefits or render the incentives less effective in promoting growth and innovation.⁸

Suggestions

- **Need for Consistent and Clear Guidelines:** FinTech companies need regulatory authorities to provide them with consistent and unambiguous guidelines in order to fully benefit from these tax incentives
- **Comprehensive Regulations for Cross-Border and Multi-Jurisdictional Operations:** Additionally, regarding cross-border transactions, developing technology, and multi-jurisdictional activities, tax authorities must publish comprehensive regulations.
- **Simplified Compliance and Targeted Support:** Startups would be better able to manage these obstacles if compliance procedures were made simpler and more focused support in the form of clarifications and educational outreach. This would foster innovation and growth within the FinTech ecosystem.
- **Formation of an All-India Commission:** Formation of an All-India Commission by the government can be a beneficial step to get detailed guidelines.

⁸ Supra Note 7.

Conclusion

New technologies and the explosive growth of FinTech companies in India have upended established financial systems, calling for a reconsideration of the tax and legislative frameworks that control them. Many obstacles still stand in the way of the efficient implementation of the numerous tax exemptions, incentives, and programs that have been implemented, such as the Startup India Initiative, Section 80-IAC, and Angel Tax exemptions. FinTech businesses face considerable compliance obstacles due to factors like cross-border transactions, ambiguity in the tax treatment of digital assets, and multi-jurisdictional tax complications. Regulatory bodies must give clear, uniform standards to address these issues, especially when it comes to cross-border operations and developing technologies. FinTech businesses would be better equipped to take advantage of tax incentives while maintaining compliance if compliance procedures were made simpler, educational outreach was increased, and specific regulatory loopholes were addressed. In addition, creating an All-India Commission specifically for the FinTech industry may be a critical first step toward reducing tax laws and promoting creativity.

