
COMPLIANCE BURDEN ON EARLY-STAGE STARTUPS IN INDIA: AN ANALYSIS OF THE LEGAL LANDSCAPE AND THE CASE FOR REFORM

Kushagra Mathur, Law College Dehradun, Uttarakhand University

Prof. Dr. Lakshmi Priya Vinjamuri, Professor of Law, Uttarakhand University

ABSTRACT

India's startup economy is expanding at a rate few could have foreseen just a decade back. Yet behind the tales of unicorns, funding and government announcements, there's a less glamorous side: the dense web of statutory compliance requirements facing early-stage entrepreneurs, often in the absence of legal advice, often while they're trying to launch their product in the market. This piece considers how existing corporate, tax, labour, intellectual property and environmental regulations place undue compliance burden on startups, especially seed and pre-revenue startups. Using the existing legal framework, DPIIT statistics and international regulatory practices, the paper suggests that India's compliance regime, primarily crafted for mature businesses, generates frictions that inadvertently stymie early-stage innovation. It then offers several policy recommendations to better tailor compliance requirements to the risks and capabilities of young firms.

Keywords: Startups, Compliance Burden, Corporate Law, GST, Labour Law, DPIIT, Regulatory Reform, India.

I. INTRODUCTION

In a report published in 2023, NASSCOM quoted a statistic that nearly 90% of Indian startups that failed pointed to regulatory matters as a key factor - not funding, not fit but red tape. It's a statistic we should pay more attention to.

India is today among the world's top three startup ecosystems, with more than 1,14,000 (DPIIT-recognised) startups at the beginning of 2024. To its credit, the government has put in place several facilitative measures such as the Startup India program (2016), tax exemptions under Section 80-IAC of the Income Tax Act, self-declaration under some labour laws, and quick company incorporation through the MCA21 portal. This is all part of a relatively friendly rhetorical structure. But the operationalisation is more complicated.

It's not that individual acts of Parliament are unreasonable. The problem is cumulative. The entrepreneur who sets up a private limited company, employs five people, receives an angel investment, registers a trademark, and leases an office, is simultaneously liable to the Companies Act, the Income Tax Act, the Goods and Services Tax, the Employees' Provident Fund and Miscellaneous Provisions Act, the Payment of Gratuity Act, various professional tax acts, the Trade Marks Act, shop and establishment acts, and potentially other sector-specific laws depending on the business. Each has its own due dates, formats, fines and enforcement agencies. None were written with a two-person team and a one-person runway in mind.

This article is an attempt to understand the interaction of these legal requirements at the early stage. Section II looks at corporate and MCA regulations. Section III looks at the tax architecture. Section IV considers labour laws. Section V examines the cost of registering intellectual property. Section VI briefly considers environmental laws. Section VII draws conclusions and outlines a reform program. The aim is not to suggest that startups should not have to comply with law - that would be imprudent and unfair to other parties. Rather, it is to suggest that laws should be scaled to size.

II. CORPORATE AND COMPANY LAW COMPLIANCE: FORM OVER SUBSTANCE?

The majority of technology startups in India are incorporated as private limited companies

under the Companies Act, 2013 (the 'Companies Act') - and for good reason. It provides limited liability, makes it easy to raise equity and creates a legal entity or person. It also comes with a filing burden that kicks in with the issuance of a Certificate of Incorporation.

The annual compliance requirements (MGT-7 - annual return, AOC-4 - financial statements, DIR-3 KYC for each director, MSME Form I if unpaid dues, BEN-2 for beneficial ownership declarations, etc.) alone can be an expensive proposition in professional fees and management time. A startup in its first year with no revenue to show for it must still comply or pay late filing fees under Section 403 of the Act. While not fatal for a bigger company, the fees can run into the thousands of rupees per delay for a cash-strapped startup with an operating bank balance of Rs 100.

The Act also requires board meetings - at least four board meetings per year, following certain notice periods and requirements to record the minutes of the meeting. Nascent entrepreneurs often operate in an "agile" mode where a decision is made on a phone call, and written minutes are produced later as an afterthought if at all. This creates a grey area of low-level non-compliance that most founders are blissfully unaware of until they raise funds and the due diligence process reveals a gaping hole in the past few years' worth of processes.

The LLP, a new structure designed to be less "burdensome", presents its own challenges - particularly when converting to a company on receipt of VC funding, and the inability to issue ESOPs - so it is not the best option for most funded startups. The one-person company, designed to be the ideal solution for the solo-entrepreneur, has turnover and capital restrictions that require conversion once the venture is successful. Most startups end up using the private limited (Ltd) company, and have to deal with all its compliance issues from the beginning.

The 2018 Companies Act amendment brought some comfort - quicker company incorporation, lower filing costs for small companies and a light-touch compliance framework for some companies. But the definition of "small company" (paid-up capital of not more than Rs. 2 crore; turnover not exceeding Rs. 20 crore) were only adjusted upwards in 2022 and do not cover many funded startups that have large levels of investment on their books but still operate with a low turnover. This means that as soon as a startup is attracting investment, it may lose its eligibility for the light touch regime and be thrust into the full compliance regime.

III. THE TAX ARCHITECTURE: GST, INCOME TAX, AND THE ANGEL TAX PROBLEM

It is the tax compliance area where the pain is most keenly felt - both monetarily and mentally. There are three different compliance streams to be considered: Goods and Services Tax (GST), corporate income tax, and until recently, the so-called angel tax.

A. GST

Once a startup's turnover exceeds Rs. 20 lakhs (Rs. 20 lakhs (Rs. But many business-to-business (B2B) startups voluntarily register much early to receive input tax credit and to project to corporate buyers as trustworthy. Once registered, the compliance burden is considerable: filing monthly GSTR-1 and GSTR-3B returns, GSTR-9 annual reconciliation and the certainty of not being able to tie up purchase invoices with supplier returns.

The input tax credit regime, which is supposed to remove cascading tax, has turned into a compliance nightmare. A startup purchasing services from a supplier who delays filing their own GSTR-1 is unable to claim ITC - and this is not their fault. This introduces monitoring costs: the founder needs to monitor their own as well as all their vendors' filing records. This is not manageable for a startup with a small finance team without the help of costly GST accounting software or an accountant.

The costs of non-compliance with GST are high. Late fees, an interest charge of 18% per annum on late payment of taxes and the threat of criminal prosecution for serious non-compliance create a risk environment in which any oversight can lead to severe financial consequences. With many founders of early-stage companies coming from a technical background with no tax background, the learning and risk curve is high.

B. Angel Tax and Section 56 (2) (viib)

Few provisions have more terrified entrepreneurs than Section 56(2)(viib) of the Income Tax Act - the angel tax. This tax treats the premium received on the issue of shares in a company above the fair market value of the company as "income from other sources" and subject to tax at a rate of around 30%. The aim was to curb money laundering by way of premiums on the issue of shares. For startups, it has resulted in the capital received at an early stage being taxed as income.

The Rule 11UA methodology for valuing shares - primarily the Discounted Cash Flow (DCF) method or the Net Asset Value (NAV) method - are particularly inappropriate for valuing pre-revenue startups where the value of the company is almost entirely attributable to the expected future growth, the quality of the team and the market opportunity - as opposed to the past performance. An angel investor who believes a startup is worth Rs. 5 crore because of proprietary knowledge and relationship, but is investing in a company with a valuations of Rs. 1 crore. The resulting Rs. 4 crore premium is taxed on the company. This is the intended or expected outcome of this provision, but it is a powerful disincentive to early-stage equity investment.

A 2023 notification from the CBDT extending the Section 56(2)(viib) to foreign investors created significant concern (before being partially reversed). This saga highlights the bigger picture: tax policy in the area of financing startups has been reactive and unstable, creating a cloud of uncertainty for founders who need certainty. The 2024 Budget announcement of the abolition of angel tax for all kinds of investors is a welcome sign - but the ten years of uncertainty before leaves a legacy in how founders and investors think about structuring early-stage financing.

C. Section 80-IAC & the Tax Holiday

The Section 80-IAC three-year tax holiday for eligible startups is more a carrot than a stick. First, it must be recognised by the Department of Promotion of Industry and Internal Trade (DPIIT). Second, it must get a certificate from the Inter-Ministerial Board - something many entrepreneurs find frustratingly slow and opaque. Third, the holiday is granted on the startup's 'profits and gains' - of little use to a company that is by construction making losses while scaling up. The provision applies to the startups that don't need it: those that are making taxable profits in the first seven years of operation.

IV. LABOUR LAWS: THE COMPLIANCE FLOOR THAT NOBODY TALKS ABOUT

Labour law compliance is likely to be the compliance area where startups will go wrong - not deliberately but through ignorance. The law is disjointed, in relevant ways state- based, and oriented to an industrial-age employment model whose relationship is ill- suited to current employment trends.

The Employees' Provident Fund and Miscellaneous Provisions Act, 1952 (EPF Act) applies to businesses with 20 or more employees - so many startups are not covered at first. But pace of growth is fast in the startup environment, and the crossing of the 20 employee threshold attracts immediate consequences: EPF registration, monthly returns (with details of PF contributions), maintenance of certain registers and annual returns. Not doing so in time leads not only to penalties but also the possibility of criminal prosecution under Section 14 of the EPF Act: a provision that is draconian given that the non-compliance is usually due to the lack of oversight of the employer's affairs.

The Payment of Gratuity Act, 1972 applies from the date of employment of ten or more employees. The Payment of Bonus Act, 1965 applies to businesses that employ 20 or more employees - and to individual employees earning monthly salaries of Rs. 21,000 per month. Shops and Establishment Acts differ between states, but typically require registration, regulate hours of work, require leave policies and require salaries and attendance registers. Each of these acts has its own inspections and registers, and its own penalties. For a small startup, with eight employees and sharing a co-working space, the cumulative compliance cost (professional, time and record-keeping) can account for a significant chunk of monthly expenses.

The four Labour Codes - the Code on Wages, 2019; the Industrial Relations Code, 2020; the Code on Social Security, 2020; and the Occupational Safety, Health and Working Conditions Code, 2020 - were meant to replace the old plethora of labour laws. They are not yet fully notified and operationalised in all the states. The result creates an odd situation: founders are subject to understand and follow pre-existing labour statutes (which continue to apply in most cases) and the new Codes (which may or may not apply in certain situations, albeit at some future date). Uncertainty is also a compliance cost.

The gig economy angle is noteworthy. Many startups in the early stages engage consultants, freelancers and platform workers rather than employees, in order to avoid working out of the statutory box. This is a sensible approach to compliance management, but gives rise to its own risks: the classification of workers who are dependent on a single platform has led to litigation in several jurisdictions and is also on the radar of regulators in India.

V. INTELLECTUAL PROPERTY: THE GAP BETWEEN REGISTRATION AND PROTECTION

For most technology and consumer startups, intellectual property is foundational to enterprise value. A brand, a software architecture, a proprietary algorithm, a product design these are the assets that investors are really funding. Yet IP registration in India remains slow, costly relative to early-stage budgets, and poorly understood by most founders.

Trademark registration under the Trade Marks Act, 1999 is theoretically straightforward. In practice, from filing to registration, the process typically takes between 18 months and three years. A startup operating under an unregistered trademark for this period has limited practical protection a passing off action is available but expensive to pursue. The Madrid Protocol allows for international trademark protection, but the costs are prohibitive for a pre-revenue company with international aspirations.

Patent protection is even more challenging. The cost of filing a complete patent application in India, including professional fees, ranges from Rs. 50,000 to Rs. 3,00,000 depending on complexity. The pendency period at the Indian Patent Office has historically been five to seven years a timeframe that effectively covers the entire commercially relevant lifecycle of many technology products. The startup may have pivoted, been acquired, or folded before a patent is granted. A 2021 Office of the Controller General expedited examination scheme has reduced pendency for startups to approximately 6-12 months, but uptake has been limited by awareness gaps and the front- loaded cost.

Copyright protection for software is automatic under the Copyright Act, 1957 no registration required. But many founders do not understand the scope of this protection, what it covers, what it does not, and how to enforce it practically. The gap between having legal rights on paper and being able to enforce them commercially is significant for a resource-constrained startup.

Trade secrets arguably the most practically important IP protection mechanism for startups have no dedicated statutory framework in India. Protection is cobbled together through confidentiality clauses in employment contracts, NDAs, and equitable principles recognised by courts. This creates enforcement uncertainty that founders typically discover only when a departing employee joins a competitor.

VI. ENVIRONMENTAL COMPLIANCE: THE SLEEPER OBLIGATION

For most tech and consumer startups, intellectual property is critical to value. A brand, an app

architecture, an algorithm, a product design - investors are investing in these assets.

Unfortunately, IP registration is slow, expensive (compared to early-stage funds) and not well understood in India.

The process of trademark registration is clear under the Trade Marks Act, 1999. However, in reality, the registration process takes between 18 months to 3 years. An unregistered trademark for a start-up company for this duration therefore offers limited protection - a passing off action can be launched but this is costly. A start-up can go multi-jurisdictional through the Madrid Protocol, but the cost of a non-revenue generating company pursuing international growth is out of reach.

Patent protection is even more challenging. The estimated cost of filing a complete patent application in India, including fees to professionals, is Rs. 50,000 to Rs. 3,00,000 depending on complexity. Previously, the pendency for an Indian patent was 5-7 years - covering the entire commercial lifespan of many technology-based products. The startup could have changed direction, sold, or failed by the time the patent is granted. An Office of the Controller General fast-track patent examination scheme was launched in 2021 for a pendency of 6-12 months, but has been underused due to lack of awareness and upfront costs.

The Copyright Act, 1957 automatically protects software - no registration is necessary. However, founders have limited understanding of the breadth of this protection, its extent, limitations and practical implications. There is a clear gap between legal rights and commercial enforcements for a cash-strapped startup.

India does not have a statutory framework for trade secrets - arguably the most important form of IP protection for a startup. Defenders piece together protection through confidentiality agreements (employment and NDAs) and principles of equity recognised by courts. And this leads to enforcement doubts that are often encountered by founders when employees move to rivals.

VII. REFORM AGENDA: WHAT PROPORTIONATE REGULATION WOULD LOOK LIKE

The case for reform is not that startups should be given special considerations on the basis of privilege. It is that regulatory calibration is a valid policy instrument - and that calibrating

compliance costs to the level of risk and the operational complexity of different classes of enterprises makes economic sense and is in accord with the goals of the laws. Here are some examples of what that could look like.

A. Unified Compliance Calendar and Rationalisation of Thresholds

The most significant process reform would be a consolidated compliance calendar - partially in place with the Udyam portal and MCA21 - to address all central and state government requirements for a given class of entity. Entrepreneurs should not need legal advice to know what they are expected to do and when. More practically, threshold triggers for compliance obligations should be revisited to discriminate between businesses that are small (in employees and turnover), medium (in turnover and sector) and large (in employees and sector) altogether not just one. For example, a startup with 25 employees and no revenue will have a different compliance burden than a profitable SME with 25 employees.

B. Startup-Dedicated Accommodations for Company Law

DPIIT-recognised startups should be allowed to convene board meetings exclusively through videoconference (it is already allowed, but with procedural restrictions), use a simplified format for their annual returns for five years from incorporation and be exempt from some of the procedural formalities (such as mandatory checks of physical addresses of the registered office) until they reach a threshold revenue. All of these relaxations do not impact the protections for creditors or minority shareholders; they merely recognise the relative costs of procedural formalism due to size.

C. Simplifying GST Filing for Startups

The GST Composition Scheme is a relief for small businesses but cannot be used by B2B service businesses requires tax invoicing. The monthly GST filing turnover threshold for startups (with reconciliation at the end of the year) could be higher or a quarterly filing choice made available for startups. The system that matches input tax credits (ITCs) and penalises buyers for vendors' non-filing needs structural overhaul: either a time-lag safe harbour for claiming ITCs or a supplier compliance score that allows buyers to claim provisional credits pending vendor filing.

D. Labour Law: Tiered Thresholds and Time-Lags

Thresholds for EPF, ESIC and Gratuity compliance should be supplemented with a revenue threshold, in addition to workforce headcount. A startup that crosses the 20- employee threshold in pre-revenue status should be accorded a benefit of the doubt for six months to register (with no penalties being levied during that period if the startup is taking reasonable steps to register). The four Labour Codes should be rolled out uniformly and fast; the current inaction maximises confusion for minimal gains.

E. IP: Fees to Protect IP and Expedited Examination

The upfront time-critical examination initiative at the Patent Office should be actively promoted and the fee subsidy continued. Establishing a cell for startup IP registration at DPIIT with IP lawyers for pro bono advice to recognised startups in the initial stages would correct this deficiency at little cost. The big challenge remains pendency at the Trademark Registry: hiring more examiners and limiting the statutory period for examining such applications (to, say, 12 months from application is filed) would go a long way towards enhancing the currency of trademark protection.

It is also advisable for India to roll out a specialised trade secret law - a step recently taken by the US with the Defend Trade Secrets Act, 2016 and the EU with its 2016 Trade Secrets Directive. The present contractual approach is insufficient and not properly enforced.

F. A Startup Regulatory Sandbox Framework

SEBI, RBI and IRDAI have established specific industry sandboxes for fintech, insurance tech and other companies. This concept should be extended: any startup recognised by the Department of Promotion of Industry & Internal Trade (DPIIT) that is engaged in a new business venture should be able to request a 24-month regulatory sandbox: a limited timeframe for operating with reduced or deferred compliance obligation in return for transparent reporting to a designated regulator. This is not an exemption, but rather a managed trial-and-error period in which the startup and regulator can learn about the necessary compliance norms.

VIII. CONCLUSION

Much talk about the Indian startup policy debate revolves around government action:

recognitions, tax holidays, fund-of-funds, incubator programs. This is not necessarily a problem - these things count. But that's where they are fixing up the headings, while the substrate remains mostly untouched. The founder who is recognised by the DPIIT as a startup and given a tax break is subject to the same filing of quarterly GST payments, the same procedures for holding board meetings, registration with EPF, the same wait for a trademark registration, and the same jigsaw of labour statute laws as any other private limited company. The administrative costs are the same for a start-up and for a medium- sized company. Legal process is applied equally - and that's the trouble.

The ideas that are submitted in this article are neither extreme nor costly. They do not propose startups being exempted from regulatory obligations: tax, labour laws, or environmental regulations. They propose variable thresholds, procedural simplifications, quick IP office work-flows, compliance portals and sandboxes. These are proportionality measures. Every jurisdiction with a RP for innovation has adopted variants of them - the UK's pro-sophistication company laws for small companies, Singapore's variable capital company, the US's SEC safe harbours for early stage funding. There's no reason why

India cannot adopt them. Perhaps what has not been in sufficient supply is political will.

The Silent Valley of startups - the ones that go out of business not because they did not have the right idea but because the entrepreneur did not have time and money to do the compliance stuff for a venture that hasn't yet earned the first crore of profits - are not front-page news. They are not collapsing failure statistics in which the compliance variable can be discerned. But they are there. Making the regulatory frameworks work for early-stage startups is not only about the unicorns. It is about making it possible for the vast majority of ventures that will not be unicorns to find that out.

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