

2008 Update to Guide to Establishing a Subsidiary in India

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Although the current dollar-rupee exchange rate is causing more consideration of other locations, many businesses in the U.S. continue to move a portion of their development, support and other operations offshore to India, primarily for cost-saving reasons. Venture capital investors may require such outsourcing in order to reduce a company's burn rate. While a U.S. company may initially contract for services with a third party in India, many companies establish their operations in India through incorporation of a subsidiary, a private limited company under the India Companies Act of 1956, as amended (the "*Companies Act*"). This memorandum summarizes certain of the legal and administrative issues that a U.S. company (the "*U.S. company*") should consider in establishing an Indian subsidiary.

Where to Locate the Subsidiary

A key factor for determining the subsidiary's location is the availability of a reliable employee pool with required skill sets for the services. Many U.S. software companies have established a subsidiary in Bangalore in the State of Karnataka because of its skilled work force and well-developed telecommunications infrastructure. Life sciences companies, by contrast, have favored Hyderabad as the center of their investment. India's technical workforce is becoming increasingly mobile within India so that it may be possible to recruit the necessary employees to other locations.

Bangalore's infrastructure, apart from telecommunications, is going through significant growing pains which makes it increasingly difficult to do business there. As a result, many U.S. companies are increasingly establishing operations in locations such as Pune and Chennai, that have lower costs, less competition for employees and a less mobile workforce. Employee benefits and other indirect and direct expenses are likely to be higher in Bangalore and Hyderabad than other places in India. Bangalore still has a pool of junior employees available but senior employees are at a premium.

Another important factor is where the potential local managing director lives in India. As discussed below, a pre-existing relationship with a potential managing director for the India subsidiary is an important practical consideration. The place of residence of this person may drive the decision of where to locate the subsidiary.

Hiring of Local Service Provider to Establish Subsidiary

The U.S. company will often hire an accountant, lawyer or other service provider in India to establish the subsidiary and complete the necessary administrative and legal requirements, such as applying for name availability, preparing the memorandum and articles of association, and tax and labor registrations. The most effective service provider tends to be in the same city where the subsidiary will be located. Some of these service providers also offer payroll, benefits and human resources support similar to what TriNet or Administaff provides in the U.S. These service providers vary significantly in terms of pricing and services and it is useful to compare cost, quality and scope of services. References should also be checked. In most cases, the U.S. company will want a written agreement with the service provider. Depending on the individual circumstances and needs of the U.S. company, there are local Indian law firms that can assist with the incorporation process. Many U.S. companies, however, complete the incorporation process through an accountant or similar service provider, without obtaining local legal counsel.

The Incorporation Process and Approximate Cost

Exhibit A contains the list of actions and estimated time schedule involved in the incorporation process. Time frames for completion of tasks may vary slightly from state-to-state in India. In our experience, the cost for establishing an Indian subsidiary through a local service provider ranges from approximately US\$7,500 to US\$20,000, including incorporation, registration and service fees, but excluding any initial capitalization provided to the subsidiary by the U.S. company. The high end of the fees would apply when one of the major U.S. accounting firms or a high-end law firm is used. As discussed above, pricing and scope of services provided by the service providers vary significantly and references should be checked by the U.S. company.

Corporate Structure: Initial Directors and Shareholders

A private limited company must have at least two directors and two shareholders. While it is not legally required that such directors and shareholders be residents of India, many service providers will recommend that the subsidiary initially have at least one local director and two local shareholders in order to efficiently complete the incorporation process. This structure avoids administrative time-delays, such as requirements that non-India residents have incorporation

documents notarized in an Indian consulate in the United States, and enables the U.S. company to quickly establish the subsidiary. Recent regulations require electronic filing and authentication of applications for name registration, incorporations and other corporate filings. Consequently, at least one of the proposed directors of the subsidiary will need to have a digital signature issued by a certifying authority approved by the Ministry of Company Affairs. All directors also must have a Director's Identification Number. The service provider can assist with acquiring these items.

If the U.S. company does not have any relationships with persons in India, the initial director and shareholders will often be the service provider or persons referred by the service provider. The practical necessity of having an initial director and two initial shareholders be residents of India presents corporate control issues for the U.S. company. The U.S. company will want to ensure that the local director and shareholders do not make expenditures or bind the subsidiary to any commitments that are inconsistent with the expectations of the U.S. company. The U.S. company should also purchase the shares of the nominal Indian shareholder(s) as soon as practicable. Any delay in purchasing the shares could result in the shares having to be acquired at a price higher than the price paid, since pricing guidelines under exchange control regulations would apply. The U.S. company would also have to comply with the formalities prescribed by the Reserve Bank of India ("RBI") for such sale of shares.

In order to maintain adequate corporate control over the subsidiary and ensure the service provider, the initial local director and the initial shareholders act in accordance with the interests of the U.S. company, the U.S. company should enter into a written agreement with such parties providing for the following structure:

Initial Board of Directors Structure

- The subsidiary will often initially authorize at least three directors. One of the three directors will be a local Indian resident to serve for an initial designated time period for purposes of establishing the subsidiary and/or as the managing director of the subsidiary (as discussed below). All other directors will be representatives designated by the U.S. company. The U.S. company may require that the local director is removable by the U.S. company at any time in its discretion.
- The directors designated by the U.S. company will often be executive officers of the U.S. company.

Only individuals may be directors and a director is not required to be a shareholder.

- The agreement between the U.S. company, the local service provider and the initial local director may also require the local director (as well as the local initial shareholders) to (i) comply with all budgetary guidelines and other written instructions provided by the U.S. company and (ii) not make any expenditures inconsistent with such guidelines or incur any other obligations without the prior written approval of the U.S. company.

Initial Shareholders

- For administrative efficiency reasons, the subsidiary will sometimes initially have two local Indian nominal shareholders. The Companies Act requires two (2) shareholders. The second shareholder should sign a written declaration that he is the nominal holder and the U.S. company the beneficial holder. These persons should be nominal shareholders for an initial designated time period for purposes of establishing the subsidiary, and such shares need to be subject to the right of purchase by the U.S. company. Transfer of shares from the local Indian shareholders to overseas companies/foreign national falls under the automatic route of RBI subject to certain valuation and reporting requirements. Transfer of shares from a Non –Resident Indian to an overseas company/foreign national requires approvals from the RBI and hence the decision on initial shareholders should keep this in mind.
- The U.S. company will also be issued shares from the subsidiary once governmental approvals are obtained. The U.S. company should consult with the service provider to ensure there will be sufficient authorized share capital of the subsidiary for the U.S. company to capitalize the subsidiary.
- The service provider should agree to not issue any other shares or ownership rights in the subsidiary except as approved in writing by the U.S. company.
- The initial local Indian shareholders should also agree to comply with all written instructions and budgetary guidelines provided by the U.S. company.

Selection of Managing Director

Selection of the managing director is an important business decision. The Companies Act provides that the Board may appoint one of the directors as the managing director of the subsidiary. The managing director is a full-time director and

is typically delegated powers similar to that of a President and CEO of a U.S. corporation. The managing director is the operational head of the subsidiary and will run the day-to-day affairs. Due to administrative practicalities, the managing director typically resides in India. The person in this position must be carefully chosen because the managing director may bind the subsidiary with third parties based on the legal theory of apparent authority, notwithstanding restrictions that may be placed on the managing director by the subsidiary's board of directors and/or in the managing director's underlying employment agreement. In some cases, the managing director is a current employee of the U.S. company who desires to go back to India to live.

Corporate Control of Subsidiary

Funding of Subsidiary and Budgetary Guidelines

One of the most effective means to maintain financial oversight is to fund the subsidiary on a monthly basis (or other relatively short time period) based on written budgetary guidelines approved by the U.S. company. Funding the subsidiary within such monthly guidelines will ensure the subsidiary acts within the U.S. company's expectations when building out its infrastructure and otherwise. It is useful for a finance officer of the U.S. company to have open communication channels with the subsidiary, such as having weekly telephone calls with the managing director or finance officer of the subsidiary, to monitor the subsidiary's expenses.

Limit of Delegation of Authority

The U.S. company may also limit the amount of authority that is delegated to the local managing director of the India subsidiary. For example, certain types of decisions may be required to be made by the full board of directors, such as any material expenditures or agreements with third parties that bind the subsidiary.

Operational Implications and Related Issues

The India subsidiary is a separate legal entity from the U.S. company. The operational relationship must be carefully documented and monitored in order to maintain the separate legal status of each company. There must be inter-company and other agreements between the companies

in order to have the intended effect for tax insulation of liability and other business purposes. One example is the research and development agreement discussed below under Intellectual Property. Another example would be a support service agreement if the subsidiary provides such services. The relationship between the companies must be "arms-length" and the U.S. Internal Revenue Service and the India Income Tax authorities may scrutinize transfer pricing between the companies. The agreements are usually cost plus arrangements, often cost plus 10- 15%. To be arms length, such agreements must contain provisions normally found in such agreements such as how the scope of services will be specified, not just tax provisions.

U.S. companies also face the issue of currency exchange restrictions. The government of India regulates the movement of funds out of India and approval may be required before cash may be transferred out of India. This is another business reason why a U.S. company may capitalize the subsidiary with cash on a monthly or quarterly basis (or other relatively short time period), so that the U.S. company would not be in a position of being restricted from moving excess cash out of India if so desired. There is an exemption from the Indian currency restrictions for the exercise of stock options for employees based in India. For further information on this exemption, see Stock Options for Employees in India discussed below.

Intellectual Property Ownership

Intellectual Property Infrastructure

Intellectual property protection is implemented in India both by statutory compliance and by written agreement. Copyright and patent protection are the primary types of statutory protection. Trademark and service mark statutory protections are also available. Statutory protection is important because it provides certain protection even if there is no agreement in place so long as statutory requirements are met. Trade secret protection is implemented by agreement. Patent protection is the strongest intellectual property protection because independent development is not a defense to a claim of infringement. While patent protection became available for drug products (rather than just processes) beginning, January 1, 2005, the scope of such protection is unclear.

¹ India has a provision in its patent law that excludes patents from being issued on drugs that have important therapeutic properties. Novartis, a major Indian drug maker, challenged this exclusion based on the rejection by the India patent office of its application for an improved version of Glivec/Gleevec for cancer treatment. Novartis asserted the exclusion was inconsistent with India's obligations under the World Trade Organization's TRIPS agreement for international standards of patentability. On August 6, 2007 the Chennai High Court dismissed the Novartis petition and deferred to the WTO to resolve the TRIPS compliance issue.

India and the United States are both members of the Berne, UCC and Paris intellectual property international conventions. Thus, intellectual property protection is available for the U.S. company's work in India to the extent an Indian national's work would be protected. Copyright protection requires no action for implementation but patent protection requires a patent to be issued. Copyright protection for software is available in India but patent protection for software is presently not available.

Enforcement of statutory and contractual intellectual property protection is a practical problem both in the U.S. and India. Therefore, practical means of protection may be important such as appointing trusted management, keeping certain components of the core technology in the U.S., careful management of the development environment in India, software fingerprints, watermarks and other measures. Injunctive relief is the most practical type of legal remedy in India. Suits for damages take years to complete and the amount of damage awards is small.

Moral Rights Issues

The scope of moral rights of an author are construed more broadly in India than in the United States, as such rights are expressly provided under Indian statutory copyright law unlike in the United States. As a practical matter, such rights have not been exercised even if not formally waived. An author's moral rights include the right to (i) retain the integrity of the work and (ii) claim authorship of the work. The integrity of a work is infringed if the work is either distorted, mutilated or otherwise modified to the prejudice of the honor or reputation of the author. The moral rights belong to the author even if a work is created pursuant to an author's employment so that the employer owns copyright in the work. Moral rights may not be assigned by an author but may be waived in whole or in part. An assignment does not alone constitute a waiver of moral rights. Agreements with employees (and contractors) need to contain an irrevocable waiver of moral rights and an obligation not to assert such moral rights.

One way to manage the issue is have development done only by employees of the subsidiary and not subcontractors. Each additional tier of relationships makes management of intellectual property ownership more difficult.

R&D Agreement Provisions

Intellectual property developed by the India subsidiary is usually assigned to the U.S. company since the U.S. company is the primary liquidity vehicle and customer relationships are directly with the U.S. company. The

IP ownership to the U.S. company is done primarily through arms-length research and development agreements, which provide that the U.S. company owns the results. These agreements must be backed up by employee invention assignment and confidentiality agreements between the subsidiary and its employees.

The subsidiary should use employees rather than contractors to the extent feasible to keep the IP ownership issue clearer. Under both the U.S. and India copyright laws, an independent contractor doing development owns the work unless there is a written assignment of ownership to the customer. Most copyright laws provide that an employer owns a work created by an employee without any further action but not by an independent contractor.

The assignment requirements under India's copyright law are materially different from those in the U.S. Under India's copyright law, to be fully effective, an assignment of ownership must be made after the completion of the subject matter of the assignment, the assignment must specify the geographical scope as worldwide or it will be India only, that there is no obligation to exercise the subject matter of the assignment and that the duration of the assignment is perpetual or the duration will be only five years.

Other types of service agreements may also be appropriate depending on the nature of the work being performed by the subsidiary, such as technical support, business process outsourcing, drug research and testing, or customer relationship management.

The key points of a typical research and development agreement between the U.S. company and the subsidiary are as follows:

- The subsidiary will agree to provide services as directed by the U.S. company. It is preferable that the subsidiary also agrees not to subcontract or otherwise use any non-employee service providers to perform the services, without the written consent of the U.S. company.
- The subsidiary will agree to keep all information provided by the U.S. company as confidential, including any intellectual property and business information as well as the service results of the subsidiary, and will agree to use such information only for the purpose of providing the services.

As an incentive to attract and retain employees, the U.S. company would usually want to grant stock options to key employees of the subsidiary to purchase common stock of the U.S. company. Indian employees are familiar with this type of compensation and higher level employees view it favorably. Lower level employees may prefer cash. Generally, these stock options are granted to the Indian employees from the equity incentive plan of the U.S. company. Effective April 1, 2007, stock options are subject to a Fringe Benefit Tax on the employer, at the time of exercise on the difference between the exercise price and the fair market value on the date of vesting. The rules for computation of fair market value have been promulgated and require valuation by a Category I merchant banker for all stock that is not listed in India. The regulations permit the employer to recover the amount of the Fringe Benefit Tax from the employee and many companies are doing so. Currency exchange controls applicable to stock option exercises by employees have been liberalized and there is presently no limit on the amount that employees are allowed to remit for this purpose. However, a purchase of U.S. company shares by a non-employee under an equity incentive plan, or otherwise, is subject to monetary limits under the exchange control regulations - presently \$200,000 per year, per person. More information can be found in Fenwick & West's "2008 Update to Granting Stock Options in India."

Use of Mauritius, Singapore or Cyprus Intermediate Subsidiary³

A tax planning consideration is whether the U.S. company should establish a wholly-owned subsidiary in Mauritius, Singapore or Cyprus to actually own the Indian subsidiary. The benefit of doing so is a reduction in capital gains taxes if the subsidiary is sold. India taxes capital gains on sales of stock in an Indian company whether or not the seller is an India tax resident. However, India's tax treaties with Mauritius and Singapore eliminate this capital gains tax if the seller is a certain type of Mauritius or Singapore entity. In most cases, however, the U.S. company is establishing the India subsidiary to serve as a captive service supplier for the U.S. company. This makes a sale of the India subsidiary unlikely other than as part of a sale of the U.S. company. Therefore, in most cases, adding the additional infrastructure of an intermediate subsidiary (particularly one in Singapore) would not likely ever provide any tax benefit to the U.S. company.

² More information can be found in our 2007 Update to Granting Stock Options in India which is available on our website (www.fenwick.com/publications).

³ More information can be found in our 2007 Update to Structuring Venture Capital and Other Investments in India which is available on our website (www.fenwick.com/publications).

In June 2005, the Government of India established a new policy for SEZs to provide an internationally-competitive and exporter-friendly environment in designated areas. The new policy permits private developers / exporting units to set up SEZs for manufacturing goods and providing services. The minimum requirement in terms of area for a SEZ for IT / software (known as sector specific SEZs) is at least ten hectares of contiguous land with a minimum built up area of 100,000 sq. meters of processing area. Where a subsidiary does not require this space on its own, it may lease space from a SEZ Developer to take advantage of the benefits afforded to a SEZ.

A SEZ is an area that has been designated a duty-free enclave and is treated as foreign territory for purposes of trade operations and duties and tariffs. STPI units, on the other hand are limited to the software, BPO and other technology enabled industries and their associated tax benefits expire as of March 31, 2009. New investments in software development for export may prefer to skip STPI in favor of immediately locating in a SEZ. Existing STPI units are not permitted to transition into SEZs.

The incentives and facilities offered to **units** in SEZs for attracting investments into the SEZs, including foreign investment include:

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units
- 100% income tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for the first 5 years, 50% for the next 5 years thereafter and 50% of the ploughed back export profit reinvested in the company for next 5 years.
- Exemption from the minimum alternate tax under Section 115JB of the Income Tax Act.
- External commercial borrowing by SEZ units up to US \$ 500 million in a year without any maturity restriction through recognized banking channels.
- Exemption from Central Sales Tax.
- Exemption from Service Tax.

- Single window clearance for central and state level approvals.

- Exemption from state sales tax and other levies as extended by the applicable state governments.

Conclusion

Careful planning and implementation of an Indian subsidiary will avoid economic and other surprises. The U.S. parent company should be fully involved and informed in working with a service provider in India to establish a subsidiary, including ongoing oversight of the incorporation process, careful delegation of responsibility, and entering into appropriate agreements with the service provider, initial shareholders and the managing director. The selection of the managing director is an important business decision because of the authority of the position. Inter-company agreements must also be prepared, which document the business relationship between the parent and its subsidiary, particularly with respect to assignments of intellectual property ownership.

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Exhibit A

Incorporation Tasks and Schedule Incorporation Task

A number of the tasks can be done in parallel after incorporation occurs.
Acting in parallel will keep the total time as short as possible.

Incorporation, including:	Start - 30 days from start
<ul style="list-style-type: none">■ Engage service provider to complete incorporation process■ Enter into agreement between parent company, service provider and initial Indian directors and shareholders■ Directors acquire Directors Identification Number and digital signature■ Checking of name availability and name reservation■ Prepare and file charter documents (Memorandum of Association and Articles of Association), with registration fee and stamp duty■ Appointment of initial directors■ Register company and pay registration and filing fees■ Collect the Certificate of Incorporation■ Issuance of shares to initial shareholders and printing share certificates■ Prepare minute book and other statutory registers	
Open bank account	Within 15-30 days of start
Tax registrations, including application for permanent account number and tax deduction number	Within 40 days of start
Registrations under professional tax, sales tax and shops and establishment laws	Within 50 days of start
Register with Software Technology Park of India (STPI)	Within 45 to 90 days of start
Approval of Customs Dept. for bond and facility license, and import/export codes	Within 60-90 days of start
Transfer of shares held by initial Indian shareholders to the parent company/nominees	Within 45 days of start
	Total Time = 60-90 days