

2007 Update to Guide to Establishing a Subsidiary in India

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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 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.

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 often 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 an NRI 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 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

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, is challenging 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 asserts the exclusion is inconsistent with India's obligations under the World Trade Organization's TRIPs agreement for international standards of patentability.

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 uncertain.

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 subsidiary is a captive service supplier. The assignment of 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.

- The subsidiary will assign ownership of all intellectual property developed or created by the subsidiary to the U.S. company. The India copyright law requirements described above must be satisfied in order for the assignment to have its intended effect. In addition, the agreement should contain an irrevocable waiver and agreement to never assert moral rights, which should also be included in each employee's invention assignment agreement with the subsidiary.
- The agreement will often include a cost-plus provision, as discussed above, in which the U.S. company agrees to pay fees to the subsidiary equal to the subsidiary's costs and expenses plus an additional margin, such as 15%. Prior to payment by the U.S. company, the subsidiary should provide detailed reports (on a monthly basis or some other short time period) of the subsidiary's costs and expenses incurred in performing the services.
- Both parties should agree to comply with all applicable laws and regulations, including any currency exchange and export control restrictions.

Employment Issues

Hiring and Firing

Employees are usually on probation status for at least three months after being hired. The probation period may be extended in the company's discretion. During the probationary period, the employee may be terminated at the sole discretion of the company, often without severance. Employees may be terminated following the probationary period but with a notice or severance period of 30 to 90 days, depending on the seniority of the employee and the length of service.

Compensation and Benefits Generally

Benefits for India employees should be competitive but not excessive. This needs to be carefully considered when the subsidiary is established or an employee benefits infrastructure can be implemented that may not be easily changed.

Compensation for employees is divided into five parts: (1) Base Compensation; (2) Flexible Expense Plan (FEP); (3) Variable Pay (incentive and performance based pay); (4) Provident Fund (similar to social security) / Pension Plan

Contribution; and (5) Corporate Paid Expenses such as providing a corporate car and mortgage interest subsidies. Retirement plans can be categorized into the Provident Fund which is similar to U.S. social security and other retirement plans. Contribution to a Provident Fund plan is mandatory and both the employee and the employer must each pay an amount equal to 12% of the employee's base compensation into the Provident Fund plan. The employer can also contribute to a pension plan trust, which is optional.

The Finance Ministry has implemented a new framework for taxing fringe benefits. A fringe benefit tax is a tax levied on perquisites-or fringe benefits – provided by an employer to its employees, in addition to the cash salary or wages paid. A fringe benefit tax will be payable by an employer at the rate of 30%, as increased by surcharges, as the case may be, on the qualifying value of fringe benefits provided or deemed to have been provided to employees. Fringe benefits include:

1. Any privilege, service, facility or amenity, directly or indirectly provided to employees, either by reimbursement or otherwise. (This excludes perquisites in respect of which tax is paid or payable by an employee.)
2. Any free or concessional ticket for private journeys of an employee and his/her family members.
3. Any contribution to an approved superannuation fund above Rs 100,000 per employee.

The fringe benefit is deemed provided when the employer has incurred an expense, or made any payment, for the specified purposes. The qualifying value of the fringe benefits deemed to be provided may range between 5% to 50% of the expenses incurred by the employer under category 1 above and 100% for items falling in categories 2 and 3 above. One consequence of this tax is that expenses such as telephone bill payments and cars provided by employers are no longer taxable to the employee since employers are taxed for the fringe benefits.

The range of percentages between categories 1 to 4 is usually: (1) Base Compensation 40% to 70%; (2) FEP 5% to 15%; (3) Variable Pay 0% to 30%; and (4) Pension Plan 12%. Unused FEP amounts should be included in the subsidiary's budget and recorded as a deferred liability to avoid surprises when unused amounts are paid on March 31.

Stock Options for Employees in India¹

As an incentive to attract and retain employees, the U.S. company usually wants 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. The U.S. company will sometimes add to its stock option plan a sub-plan for India grants. Effective April 1, 2007, stock options are subject to a Flexible Benefit Tax on the employer, at the time of exercise on the difference between the exercise price and the fair market value. The rules for computation of fair market value are being notified. 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 \$50,000 per year, per person. More information can be found in Fenwick & West's "2007 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, Singapore and Cyprus all eliminate this capital gains tax if the seller is a certain type of Mauritius, Singapore or Cyprus 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).

Special Economic Zones (SEZ)

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 companies is 100,000 sq. meters. Where a subsidiary does not require this space on its own, it may lease space from a SEZ developer or work jointly with other software units to meet the minimum criteria 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. Companies in SEZs enjoy a tax deduction for income earned in India as follows:

- 100% for the first five consecutive years.
- 50% for the next five years.
- 50% for the next five years with a condition of creation of SEZ reinvestment reserve account.

The companies also receive favorable treatment on customs duty and excise tax similar to the benefits for Software Technology Park-India ("STPI") units. STPI units, however, are limited to the software industry and their associated tax benefits expire as of March 31, 2009. One uncertainty, therefore, is how and when to transition existing STPI units to SEZs. 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.

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.

If you have any questions about this memorandum, please contact Fred M. Greguras (fgreguras@fenwick.com) or Steven S. Levine (slevine@fenwick.com) or Tahir J. Naim (tnaim@fenwick.com) of Fenwick & West LLP or S. R. Gopalan of Dawn Consulting in Bangalore, India (srg@dawnconsulting.com) (telephone: 91.80.41142626).

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: <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■ Issuance of shares to initial shareholders■ Print share certificates and prepare minute book■ Register company and pay registration and filing fees	Start - 30 days from start
Open bank account	Within 15-30 days of start
Tax registrations, including application for permanent account number and tax deduction number	Within 45 days of start
Registrations under professional tax, sales tax and shops & establishment laws	Within 30 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