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An Updated Guide to Establishing a Subsidiary in India

BY FRED M. GREGURAS, S.R. GOPALAN AND STEVEN S. LEVINE

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 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, communications infrastructure and business friendly environment. On the other hand, Hyderabad is the center of life sciences activity in India. U.S. companies are increasingly considering establishing operations in locations other than Bangalore, such as in the cities of 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 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

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. However, many U.S. companies complete the incorporation process through an accountant or similar service provider, without obtaining local India 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 U.S. \$7,500 to U.S. \$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 establish the subsidiary more quickly.

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 also should 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. These persons would be nominal shareholders for an initial designated time period for purposes of establishing the subsidiary, and such shares should be subject to the right of purchase by the U.S. company.
- 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, isolation 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 among the companies. The agreements are usually cost plus arrangements, often cost plus 10%. 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 also exist. 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. Patent protection will be available in India for drug products beginning January 1, 2005.

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 there.

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, the moral rights belong to the author. 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 agreements and development 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.

Note that other types of service agreements may also be appropriate depending on the nature of work being performed by the subsidiary, such as technical support,

business process outsourcing, drug research and testing, and 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 purposes 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 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 10%. 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

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) Pension Plan Contribution; and (5) Corporate Paid Expenses such as providing a corporate car and mortgage interest

subsidies. Base compensation is usually kept relatively low since both the employee and the corporation must each pay 12% of the base compensation into a pension plan trust. The subsidiary and the employee tend to allocate as much as possible to the FEP. Receipts must be submitted for payments under FEP and any remaining amount is paid at the end of the fiscal year March 31. Some of these expenses are taxed to the employee and some are not. The Indian tax authorities have been giving closer scrutiny to both the relative size of the FEP compensation component and what type of expenses should be taxed. 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%. The FEP unused amounts should be part of the subsidiaries budget and recorded as a deferred liability to avoid surprises when unused amounts are paid on March 31.

Employees are usually on probation status for at least 3 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.

Stock Options for Employees in India

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 at least 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 sometimes has an India supplement to its plan for India grants. If the plan complies with certain guidelines promulgated by the government of India on October 9, 2001 and the plan is registered in India with the Chief Commissioner of Income-tax, the options will have the same beneficial tax treatment as federal tax treatment of incentive stock options in the United States. Taxation is deferred until sale of the stock rather than taxed upon exercise (there is no minimum alternative tax for individuals). The U.S. company needs to review its equity incentive plan to ensure it conforms to the Indian government guidelines and file the plan in India. India's 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 persons other than employees under an equity incentive plan or otherwise is subject to monetary limits under the exchange control regulations – presently \$25,000 per year.

Use of Mauritius Intermediate Subsidiary

A tax planning consideration is whether to have a Mauritius subsidiary actually own the Indian subsidiary in order to reduce capital gains taxes if the subsidiary is sold. In this case, the U.S. company owns the Mauritius subsidiary which then owns the India subsidiary. India taxes sales of stock of an Indian company whether or not the seller is an India tax resident. However, no capital gains tax is presently payable on shares held for over a year and sold through a stock exchange, *i.e.*, India public company shares. The applicable tax rate is 10% for shares listed on a stock exchange which are held for less than a year. An India-Mauritius tax treaty eliminates capital gains tax if the seller is a certain type of Mauritius entity. Since the India subsidiary is a captive service supplier for the U.S. company, a sale of the subsidiary is unlikely. Rather, the subsidiary would only be sold as part of the sale of the U.S. company. Therefore, in most cases, adding the additional infrastructure of an intermediate subsidiary would not likely ever provide any tax benefit to the U.S. company.

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) of Fenwick & West LLP (telephone: 650.988.8500) or S. R. Gopalan of Dawn Consulting in Bangalore, India (srg@dawnconsulting.com).

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
<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■ 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	
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 and Establishment laws	Within 30 days of start
Register with Software Technology Park (STP)	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
