

CITE

Outsourcing Opportunities in India

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SOLICITORS & ADVOCATES

Topics to be covered

- Why India
- Overview of Indian legal/regulatory system
- Foreign investment in India – law and policies
- New Indian Government and its road map for foreign investors
- Outsourcing, offshoring business operations to India including
 - Structure
 - Outsourcing to 3rd party, BOT Model, R&D set-up
 - Incentives
- India entry – Key decision factors
- Current tax issues impacting foreign investor
- VAT
- Treatment of US expatriates
- Winding up operations in India
- Watch out Issues

Why India

- World's 7th largest country with 2nd largest population
- World's 4th largest economy with high purchasing power of India's middle class
- World's largest democracy
- High growth rate – 8.2% GDP in 2003-04 and growth rate of 6% per year through the 90s
- Language - English is widely spoken in all trade and commerce

Reasons for Outsourcing to India

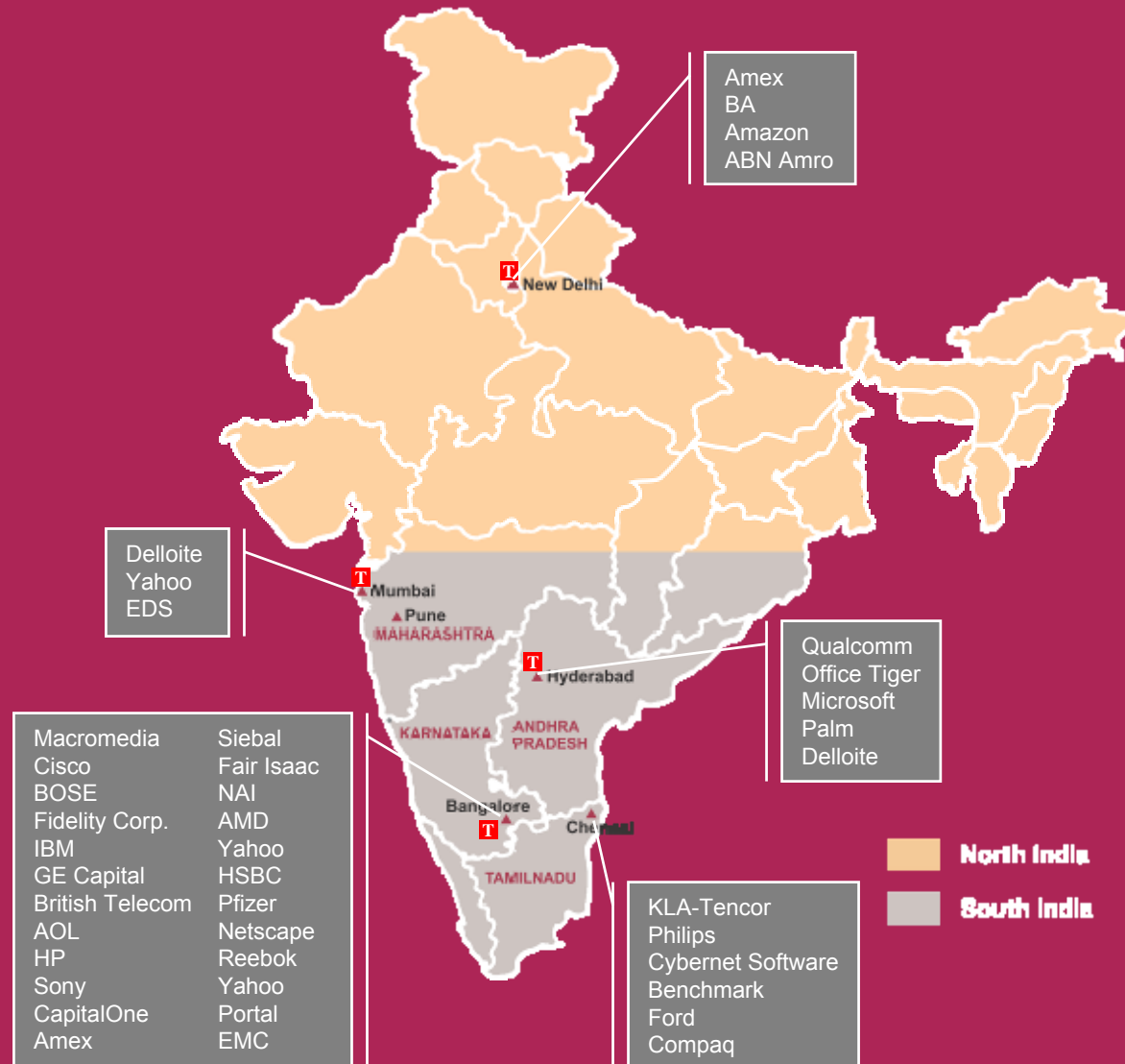
- Skilled manpower - 2nd largest pool of trained manpower in the world
- 2nd largest English speaking population in the world
- Friendly government policies for a decade to encourage Information Technology (“IT”) industry. IT is provided the highest priority by the Indian Government
- Friendly tax policies - Tax holiday to exporters till 2009; duty free import of capital goods
- High cost savings, significant value-addition
- Convenient time zone. Use of 12-hour time difference to leverage infrastructure and balance work-load from the USA

Favoured Destinations for Outsourcing (1/2)



- New Delhi / Gurgaon
- Bangalore
- Hyderabad
- Mumbai / Pune
- Chennai

Favoured Destinations for Outsourcing (2/2)



Overview of Indian Government Structure

- Central government
- State governments
- Legislature, executive and judiciary independent of each other
- Law making power is demarcated into union list, state list and concurrent list
- Foreign investment policies, corporate laws, contract law, exchange control laws, income tax laws are central legislations
- Approvals given by the Centre bind all States and municipalities

Overview of Indian Legal System

- India has a well-developed legal system, established during British rule, prior to independence
- Indian law is based on English common law; recently enacted laws are based on India's commitments under international treaties
- Almost all laws are written in English; higher courts conduct proceedings in English
- The apex court is the Supreme Court at Delhi; each state has a High Court
- Judicial remedy is fair, but delayed
- Laws provide equal protection to foreign and Indian investors

Foreign Investment Norms (1/2)

- Foreign investment laws have been substantially liberalized
- Foreign investment is not just permitted but welcomed
- Foreign Investment Promotion Board (“FIPB”) based in Delhi is the highest foreign investment approving authority. Foreign Investment Commission is likely to oversee FIPB
- Automatic approvals are monitored by Reserve Bank of India (“RBI”), India’s federal bank, based in Mumbai with regional offices throughout India

Foreign Investment Norms (2/2)

- No prior Government permissions are required for foreign investment, except when:
 - Investment in certain industrial sectors
 - Investment in excess of certain sectoral caps
 - Purchase of existing shares
 - Investor has existing venture or collaboration in India (Press Note 18)
- IT and IT enabled services (“ITeS”) are high priority industry and 100% ownership is automatic except in case of retail trading

Foreign Exchange Control

- India is regulated by exchange controls
- Exchange controls monitored by RBI
- Foreign exchange inflows permitted with minimal regulatory procedures
- Foreign exchange outflow permitted on the current account
- Foreign exchange on the capital account continues to be regulated, subject to general or specific exemption
- No exchange control approvals required for payment of dividends
- Foreign currency loans to an Indian company are encouraged, but regulated
- For purchase or sale of shares of an Indian company, permission of the RBI may be required and subject to RBI pricing norms & valuation

Contract Law & Dispute Resolution

- Indian contract law is based on English common law but codified
- Non compete provisions may not be enforceable in India
- Privity of contract as a condition to enforcement; third party to a contract can sue only in exceptional cases
- Choice of Law – enforceability of proper law of contract
- Choice of Jurisdiction – subject to court having inherent jurisdiction
- Arbitration & Conciliation Act, 1996 – based on UNCITRAL Model Law
- Enforcement of International Awards – Geneva and New York Convention Awards

Corporate Law

- Indian Companies Act based on English company law
- Two types of limited liability companies – private and public
- Two types of shares – equity and preference
- Two types of shareholder resolutions – ordinary (50.1%) and special (75%)
- Holding of 25.1% shares provides ability to block special resolution
- Holding of 10% shares provides ability to seek remedy against oppression and mismanagement
- Liquidation and bankruptcy procedures are weak and are being amended

Anti Trust Law

- Competition Act, 2002 – new antitrust law in India. All provisions are not presently in force. Provisions of MRTP applicable
- Competition Commission to regulate tie ups i.e. mergers, acquisitions, amalgamations, etc that adversely affect competition
- Competition Act, 2002 grants the Government authority to reverse mergers and acquisitions that are detrimental to competition in the relevant market
- Pre-approval of the Competition Commission could be obtained prior to implementation of the merger, acquisition or amalgamation

Intellectual Property Rights & Data Privacy (1/2)

- Based on common law
- Protection provided to Intellectual Property Rights (“IPR”) including trademarks, servicemarks, copyrights, patents and designs under specific statutes for each IPR
- Protection for both registered and unregistered IPR
- For unregistered trademarks and copyrights, passing off action under Law of Torts based on transborder goodwill and reputation. Statutory remedy for violation of registered trademarks and copyrights

Intellectual Property Rights & Data Privacy (2/2)

- Trademark Act of 1999 has been recently implemented in India. Highlights are:
 - Service marks are now registerable in India
 - Scope of 'trademark' includes shape of goods, packaging and combination of colours
 - Provides statutory protection to 'well-known trademarks' i.e. recognizes transborder reputation
 - Period of registration increased from 7 to 10 years
 - Offences relating to trademarks made cognizable; police have the right to seize and arrest without court warrant
- Presently no specific law for data privacy – protected under the Indian Constitution or by contract. Data privacy laws are in draft stage

Export & Import

- India is a member of WTO and Indian customs law complies with WTO norms
- Transaction value is the basis for customs duty
- Customs have power to investigate in case of transactions between related parties
- No customs duties on software imports
- Customs duty exemptions granted to registered exporters (50% exports)

Indian Tax Laws

- Indian revenue department has wide powers and are attracted to large transactions to fulfill performance targets
- Increasing focus of Indian revenue on activities of multinationals and expatriates in India
- New Transfer Pricing norms have been implemented
- Foreign companies are taxed @ 41.8% of net income; 20.54% for royalties and technical service fees
- Double Tax Treaty benefits are available
- Budget proposal for 2004-05 eliminates long term capital gains on sale of listed securities and reduces short term capital gains tax to 10%
- Investment in India through Mauritius may lose some of its prominence

Labour Laws

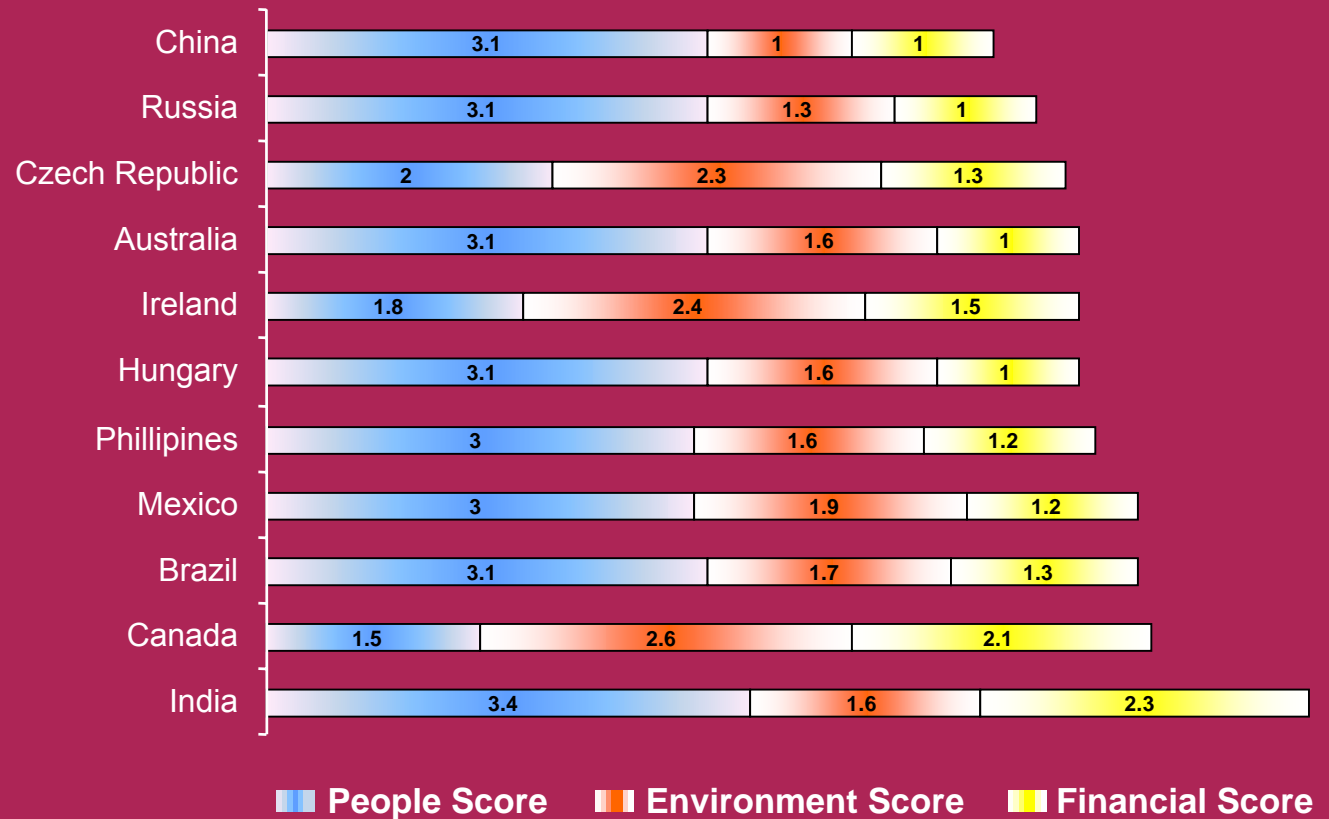
- Due to India's socialistic past, Indian laws are pro-labour but there is a move to exempt IT sector from many traditional labour laws
- India recognizes the 'employment at will' principle, but it is difficult to terminate blue-collar employees
- Indian trade unions are strong and have political backing in traditional manufacturing/service industry. Trade unions are less common in Indian IT sector
- Certain Indian states impose restrictions on 24 hour working and employment of women during the evening shift
- Non-compete restrictions may not be enforceable in India. This results in high attrition rates in the Indian IT sector
- Dual employment or contract labour is an important risk faced in India

Changes by new Indian Government

- Coalition Government with support from 2 other parties
- Was not expected to win the elections
- Common Minimum Program and its impact on FDI
- July Financial Budget announcements:
 - FDI cap raised:
 - Telecom Sector - from 49% to 74%
 - Aviation Sector - from 40% to 49%
 - Insurance Sector - from 26% to 49%
 - No excise duty on computers
 - Service tax raised from 8% to 10%
 - No customs duty on IT imports from April 2005
 - Tax concession for automobile and power sector
 - Foreign Investment Commission to be established

Offshoring, Outsourcing and Investment Potential (1/2)

A.T. Kearney assessment of attractive offshore locations

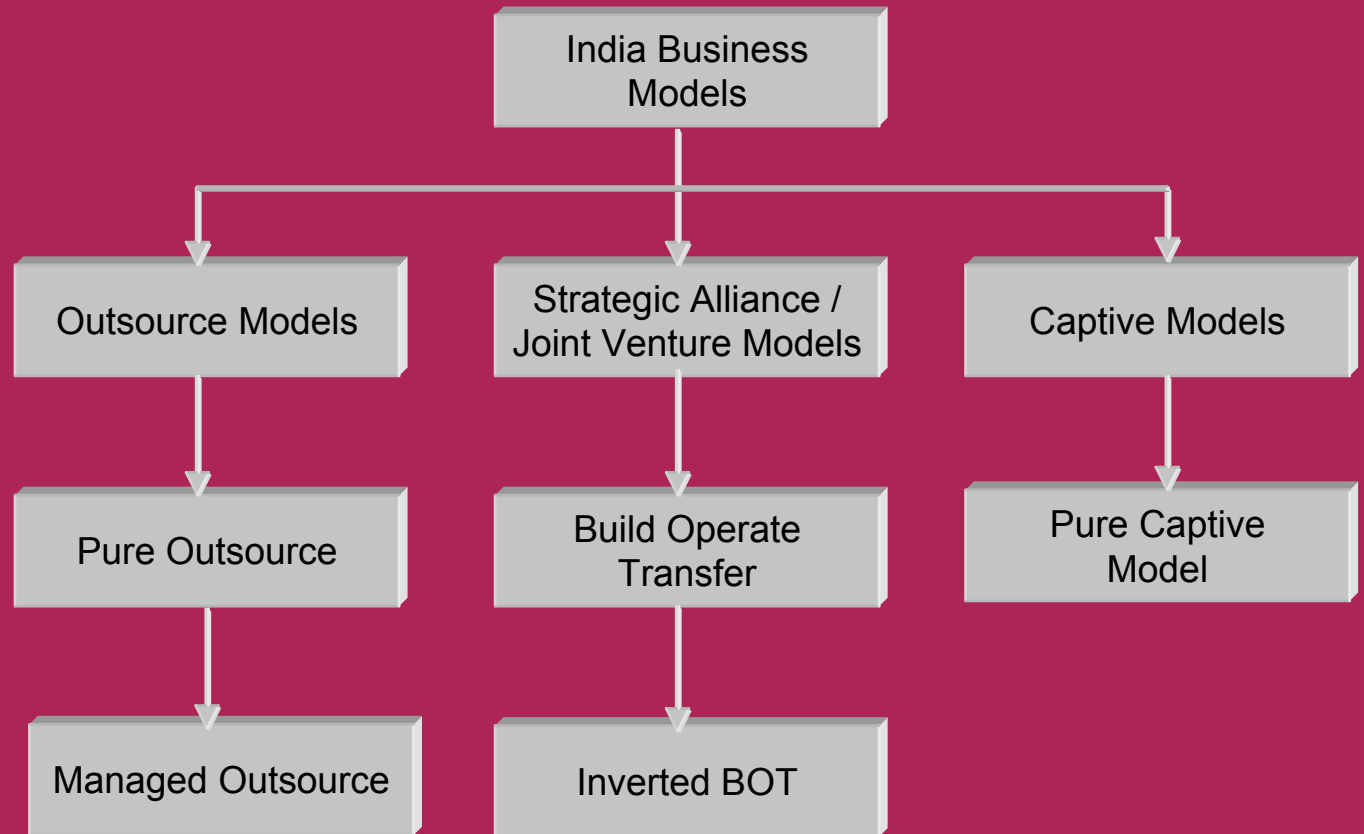


India tops the list of 11 attractive global offshore locations

Offshoring, Outsourcing and Investment Potential (2/2)

- According to the A.T. Kearney report of September 2003, India scored highest overall due to significant advantages in financial benefits offered and the quality of the local work-force
- ITeS expected to grow 60% over next 5 years
- BPO industry expected to grow to US\$ 21 billion by 2008 (viz. 25% of global BPO market)
- Reduction of 85% in turn around time could to be achieved
- Cost-savings of 50% to 70% could be achieved

Structuring Presence in India (1/4)



Structuring Presence in India – Outsourcing to 3rd party (2/4)

- Independent Contractor Agreement
 - In the form of an individual or company or joint venture
 - Nature of services exclusively contractual and no employer-employee relationship
- Confidentiality and IPR protection
- Exclusivity and non-compete issues
- Judicial recovery in case of breach of contractual rights
 - Damages
 - Injunction
- Domestic and international companies now providing services

Structuring Presence in India – BOT (3/4)

- BOT model better alternative than joint venture due to funding constraints of the joint venture partner
- BOT service receiver has the option to acquire the outsourcing facility at a future date
- Full/part time client resources in India to facilitate transition
- Equity participation from client and vendor and optional transfer clause in agreement after achieving certain milestones
- Leverage core competencies of partners, risk sharing and easier knowledge transfer
- Potential loss of control with double impact of upfront capital cost
- Viable for large transactions

Structuring Presence in India – Research & Development (4/4)

- Forms of business enterprise to set up research & development centre in India

	Liaison Office/ Branch Office	Wholly Owned Subsidiary	Joint Venture
Procedure	RBI approval required	Investment up to 100% without approvals for IT/ITeS	No approval unless shares proposed to be acquired are existing shares in an Indian company
Activities	Activities permitted by RBI LO: Non-profit BO: R&D presale, after sale support	Business on the same basis as an Indian company + minimal restrictions	Business on the same basis as an Indian company+ minimal restrictions
Statutes	FEMA	Companies Act, 1956	Contractual Arrangement

Outsourcing to India – Specific Regulatory Incentives (1/2)

- Under the Software Technology Parks (“STP”) Scheme of the Government of India, various incentives are offered to STP units. These benefits include:
 - Tax exemption for export profits until 2009
 - Duty free import of capital goods
 - Infrastructure benefits such as data connectivity, lease of premises at reduced rental, power back-up, etc.
- STP unit can be located within or outside STP
- Excise duty and sales tax benefits for domestic purchase of capital goods
- Press Note 18 does not apply to IT and ITeS

Outsourcing to India – Specific Regulatory Incentives (2/2)

- Exemption from labour laws proposed (with Left parties prominence at the Centre unlikely to go through)
- Can provide services in the domestic tariff area upto 50% of revenues (income from domestic sale however subject to tax)
- Export performance norms substantially liberalized; earlier, value addition required was 3 times CIF value of imported capital goods + 10% Net Foreign Exchange (“NFE”). Now, reduced to only NFE

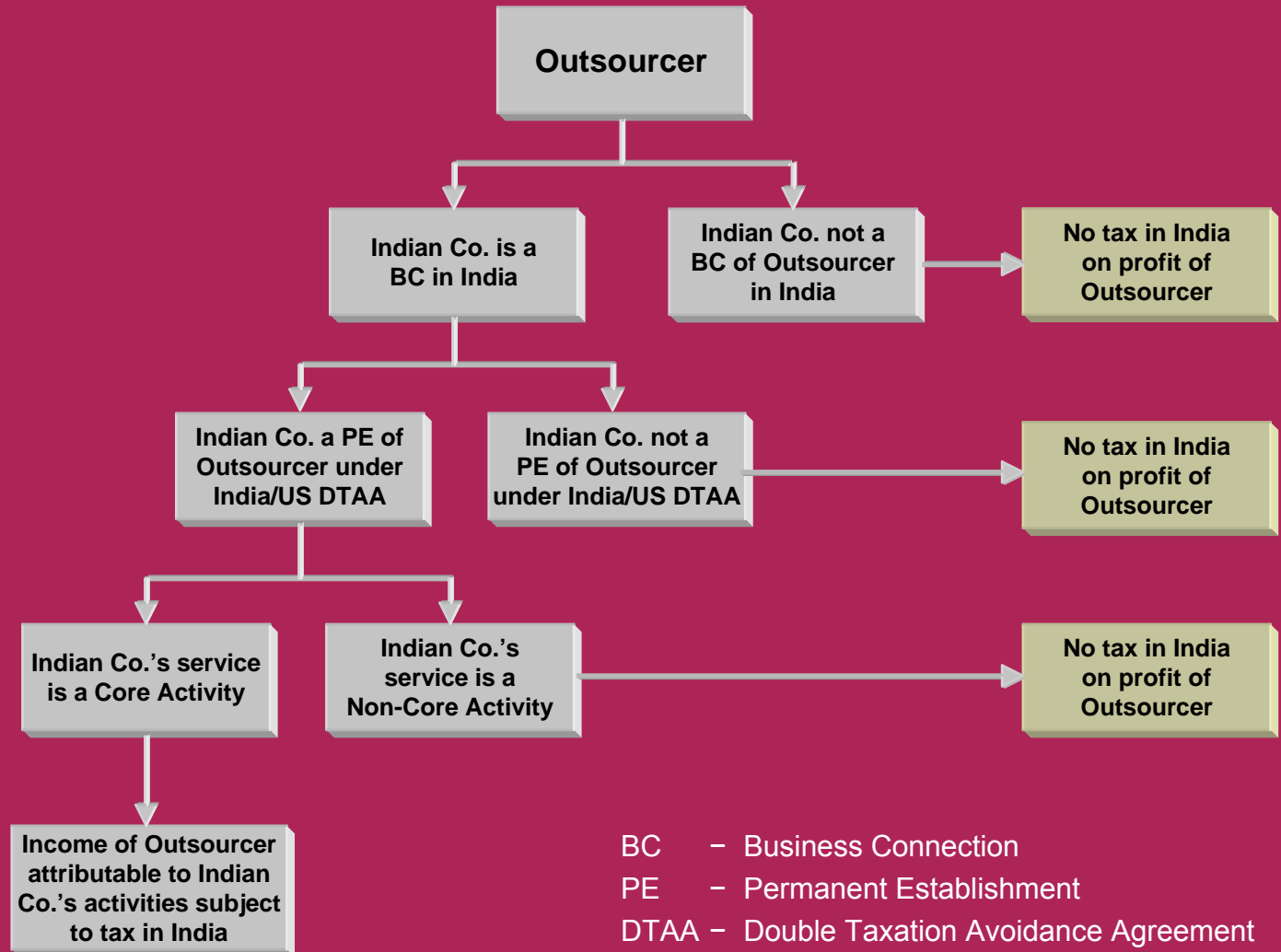
India Entry – Key decision factors

- Location
- Business structure
- Tax holiday
- Nature and extent of services to be rendered in local market
- Number of people to be hired
- Infrastructure requirements
- Duration of arrangement
- Expansion plans
- Cost benefit analysis
- Relevant US regulations
- Exit mechanism

Outsourcing to India - Tax Issues (1/3)

- Core and non-core activities distinction
- Need to ensure that Permanent Establishment (“PE”) issues do not arise
- The Indian revenue department has issued a circular dated January 2, 2004 clarifying:
 - If the outsourcing activities in India are non-core i.e. incidental to the activities of the non-Indian outsourcer, no Indian tax would be levied on the foreign outsourcer
 - However, if outsourcing activities in India are core activities of the foreign outsourcer, the global profits attributable to the activities of the Indian outsourcing unit would be subject to tax in India

Outsourcing to India - Tax Issues (2/3)



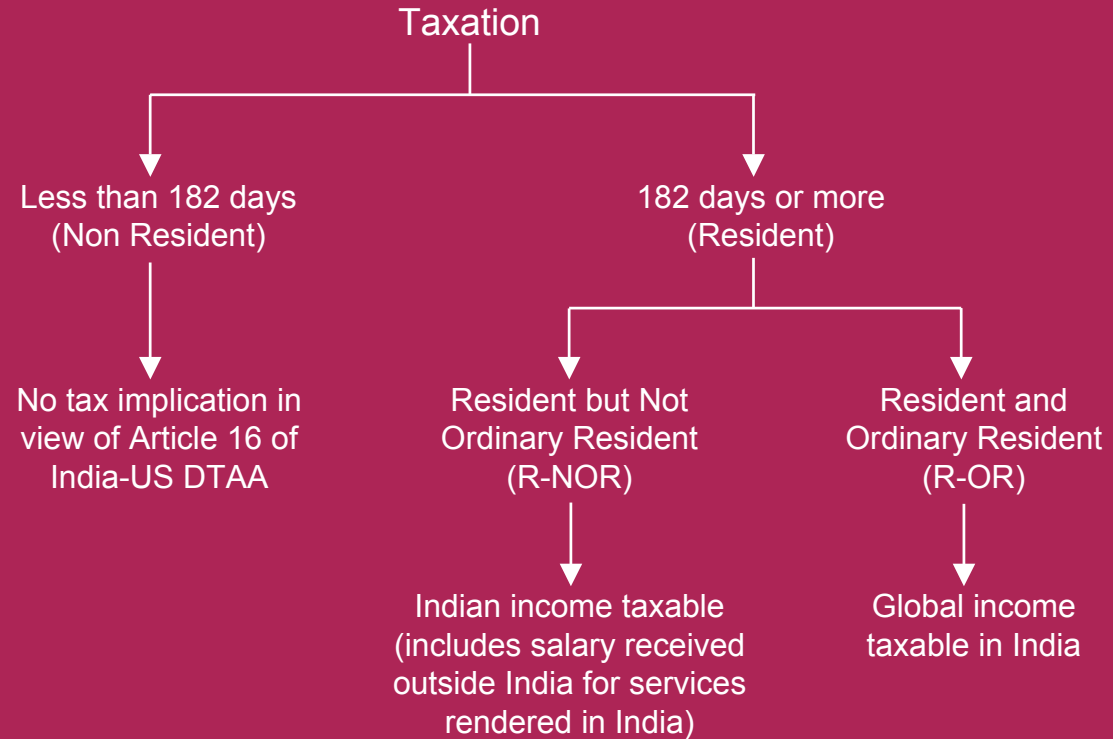
Software Licensing - Tax Issues (3/3)

- Payment for software including 'shrink-wrap' software considered 'royalty', therefore raising issues on taxability in India
- High-level committee formed by erstwhile Central Government to provide recommendation – no outcome
- Recently, Income Tax Appellate Tribunal at Bangalore in Lucent Hindustan's case has accepted distinction between 'sale of copyright' and 'sale of copyrighted product'
- 'Sale' of shrink-wrap software is therefore likely not to be considered 'royalty'

VAT

- Currently India has sales tax – no VAT
- Sales tax is levied in India under two basic statutes namely:
 - The Central Sales Tax Acts
 - The Local Sales Tax Acts
- The new Government has promised to implement VAT by April 1, 2005
- Aim - Introduction of uniform tax regime
- Effect - Replace the sales tax acts

Treatment of Expatriates – Taxation (1/2)



R-NOR → Not resident in 9 out of 10 previous years and stay in India for less than 729 days in 7 preceding years

R-OR → Resident in 9 out of 10 previous years and stay in India for more than 729 days in 7 preceding years

Treatment of Expatriates – Exchange Controls (2/2)

Both Indian nationals and foreign expatriates can:

- Remit outside India upto 75% of salaries received in India after payment of taxes under automatic route
- Receive from parent company in bank account outside in India upto 75% of salaries subject to payment of Indian taxes

Winding up operations in India

- The Indian Companies Act, 1956 provides three methods of winding up in India:
 - Compulsory winding-up by the Court
 - Voluntary winding-up by members or creditors
 - Winding-up subject to supervision of the Court
- Debonding and customs duty implications on goods imported without payment of duty (in case of STP unit)
- Domestic goods subject to payment of excise duty and sales tax
- Penalty on non-completion of export obligation (possible in theory, generally not levied)
- Employee severance package (Voluntary Retirement Scheme)
- Time and effort – could take 1-2 years

Watch Out Issues

Outsourcing - General

- Determine effect of north-south divide on your business location
- Due diligence and reference checks of outsourcing partner particularly on non-compete issues
- Employment is for life – build in simple exit mechanisms
- Do not provide employment offer in parent company's name. Hiring should be by Indian company
- Dual employment risk
- Taxation of expatriates
- India currently does not have any specific data protection laws
- US law barring sub-contracts to India

Watch Out Issues

Outsourcing - Operational

- Prepare capital goods projections with care, since list needs approval from STPI
- Do not remit funds from foreign parent company to vendors directly – has to be through India subsidiary
- Determine funding options in advance, need to mention the purpose clearly in FIRC
- Monthly reporting to RBI in case funding through External Commercial Borrowing i.e. foreign loans
- Movement of equipment out of bonded warehouse restricted

Watch Out Issues Outsourcing - Tax

- Tax and other exemptions must be identified and applied for immediately upon incorporation
- Need to ensure that PE issues do not arise against January 2, 2004 circular
- 80 : 20 Rule – do not use second hand equipment and machinery (items not used in India before not considered second hand)
- Shift of STP unit from one place to another “reconstruction or reconstitution of business in existence” – loss of tax holiday

Watch Out Issues

- Indian Government supportive of reforms but dependant on minority parties
- Delays in implementation of business proposals due to regulatory procedure at state and municipal level
- Indian laws are pro-labour
- Dangers of false familiarity
- Bargaining is part of the culture, but in limits
- Delay in litigation; commercial settlement better than long-drawn litigation
- Less protection for IPR
- Corruption and its impact under FCPA
- Exit strategy evaluation

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Outsourcing
Opportunities in India

Thank You

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