

The first foreign subsidiary: decisions that are expensive to reverse

Where to incorporate, how to fund it, and where it is really run from: the choices worth settling before the first entity is registered abroad.

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AT A GLANCE

- Choose the jurisdiction for where the business will actually operate and hire. Treaty benefits without substance are now a liability, not an advantage.
- The mix of equity and debt fixes your options for bringing cash home years in advance. Equity is easy to send and hard to bring back, and each alternative comes with conditions.
- If the foreign company is run from a conference room in India, Indian tax law may treat it as resident in India. The place of effective management test is the most underpriced risk in structures founders set up themselves.
- The overseas investment compliance calendar is short but strict. Miss the annual performance report and the group's next outbound remittance stalls.

The trigger is almost always commercial, and almost always urgent. A US customer insists on contracting with a US entity. A project in the Gulf needs a local presence. A founder moves to Dubai or Singapore. Under India's overseas investment rules the mechanics are quick, and a first outbound investment can be completed through an authorised dealer bank within weeks.

That speed is the problem. Incorporation is the easy part, and it can be undone. Three decisions tucked inside it cannot be undone so easily, and they deserve more thought than they usually get.

Decision one: the jurisdiction, with substance ahead of treaties

Ten years ago, conversations about outbound structures began with treaty maps: which country offered the lowest withholding tax on dividends back to India, the best capital gains article, the lightest controlled foreign company rules. That era has ended. Between the principal purpose test in the multilateral instrument, economic substance laws in the traditional holding jurisdictions, and Indian case law on beneficial ownership, a holding company chosen purely for its treaty is no longer a tax plan. It is a future dispute file.

The sensible order today is the reverse of the old one:

1. **Where will the business actually operate?** Look at customers, contracts, employees, and bank accounts. If the answer is the United States, incorporate in the United States. Putting a third country between India and the operating market needs a reason that survives being explained to a tax officer.
2. **Will there be real regional activity?** A Singapore or UAE holding company earns its place when it will house regional management, shared services, or funding activity, meaning people, premises, and decisions. Only then do its treaty and tax features become lasting advantages.
3. **What does an exit look like?** Future investors and buyers have preferences about jurisdiction; US venture capital's comfort with Delaware is the obvious example. Structuring for a plausible exit is legitimate planning. Structuring for a hypothetical treaty benefit is not.

Decision two: the funding mix is really a repatriation decision

How you capitalise the subsidiary on day one decides which doors are open when cash needs to come home in year four. The instruments behave very differently on the way back:

- **Equity** is simple going out and inflexible coming back. Cash returns as dividends, taxable in India with credit mechanics that depend on the country, or through capital reductions and buy-backs that are slow everywhere.
- **Shareholder debt** gives a contractual route home through interest and principal. It also brings withholding tax, transfer pricing scrutiny of the interest rate, and thin capitalisation limits in the host country, and it has to fit within the financial commitment framework of the overseas investment rules.
- **Charges for real services**, such as management fees, royalties, and shared-service charges, do most of the work of repatriation over time, and attract the most disputes. They work when the service is real, documented, and priced on a defensible transfer pricing basis from the first invoice, not reverse-engineered in year three.

EXHIBIT 1

The funding mix chosen on day one decides which routes home are open in year four

How the usual instruments behave when capitalising a foreign subsidiary, and later bringing cash back

Instrument	Sending cash out	Bringing cash back	Tax and pricing exposure	Watch for
Equity	Simple; reported through the authorised dealer bank	Dividends, or capital reduction and buy-back procedures that are slow in most countries	Dividends taxed in India, with foreign tax credit depending on the treaty	Minimum capital and dividend restrictions in the host country
Shareholder loan	Permitted within the overseas investment framework	Interest and principal repayments under the loan agreement	Arm's length interest rate; withholding tax in the host country	Thin capitalisation and interest limitation rules abroad
Charges for real services and IP	Not a funding route	Management fees, royalties, and shared-service charges	The most scrutinised flow; benchmark it from the first invoice	Evidence that the service was actually provided
Guarantees	No cash moves, but it counts as a financial commitment	Guarantee fees, where charged	Arm's length fee; exposure if the guarantee is called	Reporting requirements and limits on total commitment

A summary for orientation. Outcomes depend on the country, the treaty, and the facts.

Source: Foreign Exchange Management (Overseas Investment) Rules and Regulations, 2022; income-tax law; SA&A analysis

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The pattern we recommend for most first subsidiaries is unexciting. Put in enough equity for credibility and local regulatory needs. Agree an intercompany services framework in advance, with documentation kept as you go. Use debt only where there is a real funding gap, and do the paperwork for every instrument as if the audit were next quarter.

Equity is easy to send and hard to bring back. The capitalisation decision on day one is really a repatriation decision for year four, made early.

Decision three: substance, or the subsidiary that never left India

The most underpriced risk in structures founders set up for themselves is the place of effective management. Indian tax law treats a foreign company as resident in India if its effective management, the place where key commercial decisions are in substance made, is in India. Consider a Delaware company whose every decision is taken by two founders in Bengaluru, with

no local director who decides anything, no local bank signatory, and board minutes signed in Koramangala. It runs a real risk of being treated as exactly what it looks like: an Indian company with American stationery.

The consequences add up. The foreign company becomes tax resident in India, permanent establishment questions arise in both directions, and because the structure was priced on the assumption of foreign residence, the group's tax model was wrong from the start. The ways to reduce the risk are practical rather than clever:

- Real decision-making authority abroad, shown by who signs, approves, and spends;
- A board and meeting practice that reflect where management actually happens;
- Minutes, written at the time, that record decisions being made where they are said to be made;
- And honesty at the design stage. If the company really will be run from India for its first years, structure and price it for that, instead of pretending otherwise.

The compliance calendar: short, with hard deadlines

India's overseas investment regime is not heavy, but it does not tolerate neglect, because it is enforced through the banking system. For a typical first subsidiary the calendar looks like this:

1. **At the time of investment:** the outbound remittance is reported through the authorised dealer bank on the prescribed form, with a unique identification number issued for the foreign company. Without that number, the remittance does not go.
2. **Every year:** the annual performance report on each foreign company, due by 31 December and based on its audited financial statements, and the Reserve Bank's return on foreign liabilities and assets in July. A pending annual performance report blocks new outbound remittances for the whole group, which is how a forgotten form turns into a stalled acquisition.
3. **On particular events:** restructurings, disinvestments, changes in shareholding, and write-offs each carry a reporting requirement with a deadline measured in days rather than quarters.
4. **All the time:** transfer pricing documentation for every intercompany flow, kept up to date. The Indian master file and local file thresholds arrive sooner than growing groups tend to expect.

The one-page test

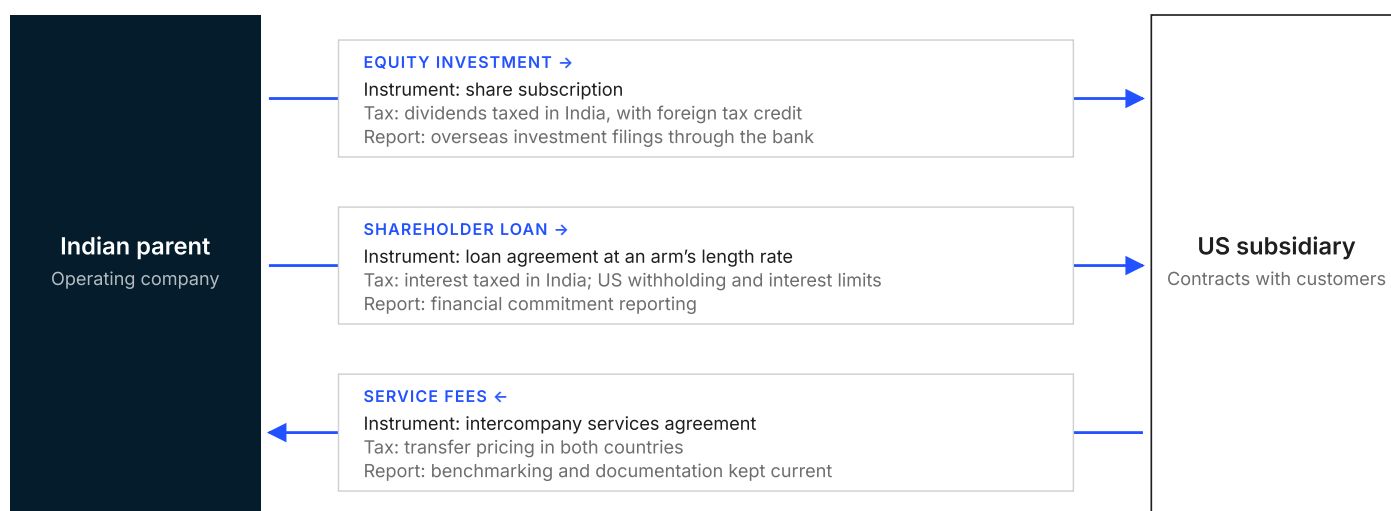
Before incorporating anywhere, we ask clients to do a one-page exercise. Draw the structure, then write three facts on every arrow: the legal instrument, the tax treatment at both ends, and the regulatory approval or report it triggers. If any arrow cannot be annotated, the structure is not ready. It sounds trivial. In practice it brings out the unresolved questions, such as who owns

the intellectual property, how the founder's salary flows, and which company contracts with the customer, that otherwise get settled by accident, in whatever way the first invoice happened to be raised.

EXHIBIT 2

Before incorporating abroad, every arrow in the structure should carry three facts

The one-page test, illustrated for an Indian parent setting up its first subsidiary in the United States



If any arrow cannot carry all three facts, the structure is not ready.

Illustrative and simplified. The tax and reporting consequences of each flow depend on the treaty, the facts, and current rules in both countries.

Source: Foreign Exchange Management (Overseas Investment) Rules and Regulations, 2022; SA&A analysis

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A first foreign subsidiary means running a small multinational, with all of a multinational's obligations and none of its infrastructure. Groups that give the first month's structural decisions that level of seriousness spend the next decade executing. The others spend it regularising.

ABOUT THE AUTHOR

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This article reflects the author's understanding of the relevant laws and standards at the date of publication. It is general in nature and is not a substitute for advice on specific facts.

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