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Indian businesses investing in the US – Tax Challenges – Part I

Date : July 06 2015

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Introduction

Once an Indian company decides to invest in the U.S., U.S. tax law will affect the business in a variety of ways. This article serves as an overview to aid the Indian tax practitioner in advising their clients who seek to expand their operations in the U.S. Part II will address direct operations by an Indian owned U.S. subsidiary in the U.S., its relationship to the U.S.-India Income Tax Treaty ("Treaty") and introduce some strategies that the practitioner could consider when advising their client.

Indirect Operations

If income generated by the Indian entity is not considered "effectively connected" with a U.S. trade or business and treaty relief is unavailable, then the U.S. source income is generally subject to a 30% withholding tax if it is considered "Fixed, Determinable, Annual or Periodic" ("FDAP"). FDAP income largely consists of items of income such as interest, dividends and royalties. As will be seen in Part II, treaty relief may be available to reduce FDAP withholding. Further, FDAP income can also be reduced or eliminated through various means in the Internal Revenue Code, ("Code") such as U.S. sourced interest which qualifies for the portolio interest exemption.

Direct Operations

If the income generated by the operation is considered to be "effectively connected" ("ECI) with a "U.S. trade or business" ("USTB"), then the income will be subject to taxation at graduated rates in the U.S (and avoid FDAP withholding). An Indian company that is engaged in a USTB has tax exposure from:

- The U.S. federal corporate income tax;
- Federal branch profits tax on the dividend equivalent amount arising from taxable income and;
- State income tax

1. U.S. Trade Or Business

For an Indian corporation operating in the U.S. to be considered a USTB, it must engage in activities that are considered "considerable, continuous, and regular". Whether the activity is "considerable, continuous and regular" is a question of fact. The Indian corporation may be a USTB even if the activities are carried out by its agent. However, a USTB will not exist if the activities are carried out by an independent subcontractor who is acting in the course of the subcontractor's business.

2. Effectively Connected Gross Income

Once a USTB exists, the tax practitioner must then analyze whether the income is "effectively connected" with the USTB. In only limited circumstances is foreign-source income deemed to be ECI and then only if a U.S. office exists and personnel assigned to that office materially participate in producing that income.

1. Services Income is sourced to the place where services are performed. Fees for services performed in the U.S. are taxable; fees for services performed outside the U.S. are not. The identity of the customer is irrelevant in determining the source of the income. Only the portion of the fee considered to be U.S.-source income will be treated as ECI.
2. Income from the purchase and sale of inventory is generally sourced by reference to the place where title passes. Title passes at the place where risk of loss passes. In the U.S., risk of loss is generally defined as the place where the seller has successfully fulfilled his obligation and awaits payment. However, a sale of inventory through a fixed place of business may be sourced in the country where the

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office or fixed place of business is located. For Indian residents, if the sale is attributable to a fixed place of business in the U.S., the income is considered to be U.S.-source income. This rule applies to all sales of personal property by nonresidents, including inventory, with the exception that a sale of inventory property for use, disposition, or consumption outside U.S. will be considered to generate foreign-source income if a foreign office or fixed place of business materially participates in the sale.

3. Income From Manufacturing Outside The U.S. Where an Indian business manufactures property outside the U.S. and sells that property inside the U.S., only a portion of the income will be deemed to be U.S.-source ECI. The portion of the U.S. source ECI income is determined by a taxpayer elected method. The portion is determined by one of two taxpayer elected methods: an independent production price or an apportionment of the income between U.S. and foreign sources.
4. Passive Income: When a foreign corporation is engaged in a USTB, items of passive income such as interest income and gains may be treated as ECI if the passive income is attributable to assets used or held for us by the trade or business.

Deductible Expenses

To determine whether expenses are deductible, the taxpayer should differentiate between:

- The expenses incurred in the U.S. to generate ECI
- The expenses incurred outside the U.S., whether directly or indirectly, in the generation of U.S. income

The analysis must be completed on an account by account basis. Even if the expense is deemed to be deductible in principle, it must not exceed U.S. tax law limitations.

Expenses which are entirely related to U.S. source fee income are deductible in full. Expenses which are entirely related to non U.S. source fee income are not deductible. Expenses which are accrued in part to U.S. source and in part to foreign source fee income are apportioned under a “reasonable method” standard which must be applied consistently from year to year.

In computing deductible expenses, the I.R.S. will attempt to ensure that expenses have actually been incurred, that they are of a kind that is deductible under U.S. concepts, that limitations of U.S. law are appropriately applied, and that expenses related to foreign operations which do not produce ECI are not deducted on the U.S. tax return. If a deductible item is paid to a related party outside the U.S., an examiner will attempt to confirm that the expenditure does not exceed an arm’s length amount within the meaning of U.S. tax law.

Branch Profits Tax on Dividend Equivalent Amount

In addition to the regular income tax, an Indian corporation that is engaged in a USTB is subject to a 15% branch profits tax on the “dividend equivalent amount”. The branch profits tax is imposed only if the U.S. branch repatriates U.S. earnings back to the Indian home office.

The dividend equivalent amount (upon which the branch profits tax is based) is the Indian corporation's effectively connected earnings and profits determined without reduction for dividends paid during the year. The earnings are reduced by reinvestment in a USTB and are increased by reductions of investments that were used in prior years to shelter the dividend equivalent amount. If U.S. asset investment increases, profits have been retained in the U.S. and no equivalent of a dividend has been effectively distributed to foreign shareholders. In general, a foreign corporation is not subject to the branch profits tax for the taxable year in which it completely terminates its USTB.

When a business carried on by a U.S. branch is incorporated, the transfer of assets to a U.S. corporation is not treated as a termination of a business. Rather, the incorporation is treated as a reduction of net equity. Consequently, deferred branch profits tax will be triggered because net assets will be reduced. This treatment is subject to an exception where the foreign corporation and its wholly-owned U.S. subsidiary elect for the transferee to step into its shoes with regard to the non-previously taxed, accumulated effectively connected earnings and profits. In doing so, the U.S. Corporation will be treated as if it has carryover earnings and profits. Moreover, dividend distributions to the foreign corporation from the earnings will qualify for treaty benefits only when the limitation on benefits provision of the treaty and its counterpart in the branch profits tax regulations are satisfied. Additionally, the foreign corporation must agree to terminate deferral of the branch

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profits tax in the event the shares of the U.S. transferee are sold or otherwise disposed of other than in an F-reorganization or a complete liquidation of the transferee, which is covered by Code §332.

A final issue relates to the benefit of net operating loss carryovers. The branch profits tax on dividend equivalent amounts is based on the annual earnings for a particular year. Consequently, it is not reduced by a loss carryover from earlier years.

State Taxes

While a discussion of state taxes applicable to a foreign entity engaged in business in the U.S. is beyond the scope of this article, certain issues should be highlighted:

- The tax practitioner should know the tax base under state law may be determined differently as compared U.S. federal law (and thus not determined by reference to the ECI rules as seen above)
- Items that are deductible for Federal tax purposes may not be deducted for state tax purposes.
- Income tax treaties of the U.S. do not apply to the various states, except for certain nondiscrimination provisions.

Conclusion

Expanding operations to the U.S. may present the Indian tax planner with various traps to be avoided. Part II of this article will analyze the U.S.-India Tax Treaty, Permanent Establishments, U.S. subsidiary transactions, and planning solutions.