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Tax Planning For Indian Businesses Investing In The U.S. Part II

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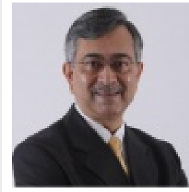
Kenneth Lobo (Managing Attorney, Ruchelman PLLC, Toronto)



Jairag Purandare (Founder Chairman of JMP Advisors Pvt Ltd)

Click here to read Part 1.

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. As a follow up to the overview that was provided several months ago, this article will address the tax consequences of a U.S. branch of an Indian company operating directly in the U.S., a U.S. subsidiary owned by Indian persons, and the application of the U.S.-India Income Tax Treaty ("Treaty"). It will introduce some strategies that the tax practitioner should consider when advising their client who seeks to expand in the U.S.

Permanent Establishment – A Treaty Concept

Virtually all treaties raise the level of presence that must exist in a nation state before that state can impose tax on "business profits," the treaty term that is used to describe effectively connected income. Business profits derived by a resident of one of the countries (the "resident state") can be taxed in the other country (the "host state") only if a permanent establishment ("PE") exists in the host state. In broad terms, a PE is a fixed place of business through which business is conducted in whole or in part in the host state. It typically includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry, or other place of extraction of natural resources. Also included are agents, other than independent agents described below, that have and habitually exercise an authority to conclude contracts that are binding on the enterprise.

Certain items are typically excluded from PE Status such as facilities which display goods or a fixed place of business having as its sole purpose the purchase of goods and merchandise.

The presence of an independent agent in the host state is excluded from being a PE, provided that the agent is acting in the ordinary course of its business of representing customers as an independent agent. The agent must be both legally and economically independent and must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise. At times, this provision is abused by small- or medium-sized foreign companies that wish to avoid the compliance requirements of U.S. tax law that are applicable to intercompany transactions. The typical example is an undercapitalized agent having a single principal that funds all costs and controls how the agent runs its business.

Treaty Benefits

As mentioned in Part I, U.S. tax law imposes a 30% tax on items of fixed and determinable annual and periodic income of a foreign corporation or a non-resident, non-citizen individual. However, the rate of withholding tax may be reduced or eliminated by an income tax treaty of the U.S. While common themes exist among all treaties, each treaty is unique and must be checked to determine whether it reflects common provisions. For example, in the Treaty, direct investment dividends are taxed at a rate between 15% and 25% depending on the percentage of ownership of the corporation, and interest is taxed at rate of 10% to 15% depending on

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whether the lender is a financial institution. These rates are relatively high in comparison to most treaties of the U.S.

The benefits provided by income tax treaties contain a safeguard intended to prevent inappropriate claims of treaty tax benefits. The provision is known as "the limitation on benefits article of a treaty, which is located in Article 24 of the Treaty. The policy ensures that a reduction in U.S. withholding tax should be used only as a means of avoiding actual double taxation.

Several broad themes exist under which a foreign corporation may qualify for treaty benefits. For example:

- Paragraph 3 treats publicly traded companies as qualified residents.
- Paragraph 1 treats companies that are primarily owned by resident individuals or U.S. residents and citizens (or a combination thereof) as qualified residents if base erosion is absent. Base erosion means that the corporation is a conduit to residents of third countries so that the tax base in the treaty jurisdiction is eroded by deductible payments to persons not subject to tax in that country or the U.S.
- Paragraph 2 treats companies that are engaged in an active trade or business as qualified residents with regard to income derived in connection with or incidental to that business.

If a company does not qualify for general treaty benefits, it may, nonetheless qualify on a discretionary basis if the competent authority of the U.S. rules that treaty benefits should be allowed based on facts and circumstances.

Transactions Between U.S. Subsidiary and Foreign Affiliate

U.S. tax law imposes several distinct obligations on U.S. companies that are owned substantially by foreign persons or that are controlled by foreign persons. In some instances, the obligations may limit or defer deductions. In other instances, the obligation mandates reporting so that an examiner can be prepared to question certain intercompany transactions under U.S. transfer pricing rules. In either event, the preparation of the tax return for the affiliate must take these provisions into account.

A. Reporting Transactions

When a U.S. company that has substantial foreign ownership enters into a transaction with a foreign affiliate, an obligation exists to report the amount of the transaction to the I.R.S. The obligation is imposed by reason of Code 6038A and 6038C so that the I.R.S. can determine the true taxable income of the 25% foreign-owned corporation under U.S. law. Each reporting corporation is required to make a separate annual information return on Form 5472 with respect to each related party with which it engaged in a reportable transaction during the taxable year. The information must be furnished even if the particular item does not affect the amount of any tax that may be due.

For a corporation to be 25% foreign-owned, it must have at least one direct or indirect 25% foreign shareholder at some point during the taxable year. The ownership threshold is met if a foreign person owns at least 25% of either (i) the total voting power of all classes of voting stock of the reporting corporation or (ii) the total value of all classes of stock of the reporting corporation. Rules of constructive ownership are applicable and the tests are applied on the basis of facts and circumstances test. The constructive ownership rules treat one taxpayer as owning shares that are owned by another person in certain specified circumstances involving related corporations, partnerships, and trusts or options.

In determining whether a reporting corporation that is a member of a partnership or L.L.C. has engaged in a transaction with a related person, all transactions of the partnership may be attributed to the reporting corporation on a pro rata basis, determined by reference to relative partnership interests. The rule applies if the reporting corporation directly or indirectly owns a capital or profits interest which by itself, or when added to the partnership interests owned by related parties, comprises 25% or more of the total interests in the partnership. The effect of this rule is to cause the reporting corporation to treat the partnership transactions as its own for purposes of the reporting, records maintenance, monetary penalty, agent for service of process, and production of records rules of the regulations.

A transaction is reportable even if monetary consideration is not required or is only part of the contemplated

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consideration. This, of course, is difficult for outside accountants to track. Typical examples involve shareholder guarantees and provision of services without charge.

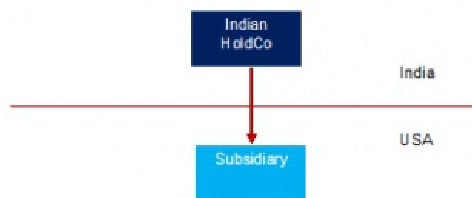
Three principal exceptions are provided to the filing requirement. First, no reporting is required if a reporting corporation has no transactions during the year with any related parties. Second, if the reporting corporation is a foreign corporation for which all reportable transactions are with one or more related domestic corporations that are not members of the same affiliated group, the foreign corporation is excused from listing those transactions. Finally, no reporting is required with regard to a reportable transaction with a related corporation if a U.S. person controls the reporting corporation and files Form 5471 that fully describes the reportable transaction.

Form 5472 is to be filed with the reporting corporation's income tax return.

Planning solutions

Outbound investment from India would require an analysis of the applicable Indian tax laws and exchange control regulations.

Structure 1



Direct investment

Key considerations from an income tax perspective

The U.S. subsidiary can repatriate funds to the Indian HoldCo by way of dividend or royalty for knowhow or Fees for Technical Services ('FTS').

Dividend would be taxable in India at 15% plus surcharge and education cess as applicable, provided the Indian HoldCo holds at least 26% of the equity capital of the subsidiary. Credit would be available for the tax withheld on the dividend in the U.S. However, no underlying tax credit is available under the Treaty.

Royalty and FTS would be taxable in India at 30% plus surcharge and education cess as applicable, subject to credit for U.S. withholding taxes and generally should also be allowed as a deductible expense for the subsidiary in the U.S.

Indian Place of Effective Management ('POEM') provisions as per Indian POEM could be applicable by reason of which the profits of the U.S. subsidiary may be taxed in India. However, this would have to be analyzed on the basis of facts of each case.

Branch v. Subsidiary

- The U.S. branch would be treated as a PE of the Indian HoldCo in the U.S. and its profits would be taxable in India at 30% plus surcharge and education cess as applicable with a credit for foreign taxes.
- Losses of the branch can be set off against the profits of the Indian HoldCo, which is not the case for a subsidiary.

Structure 2

Investment through an intermediary holding company

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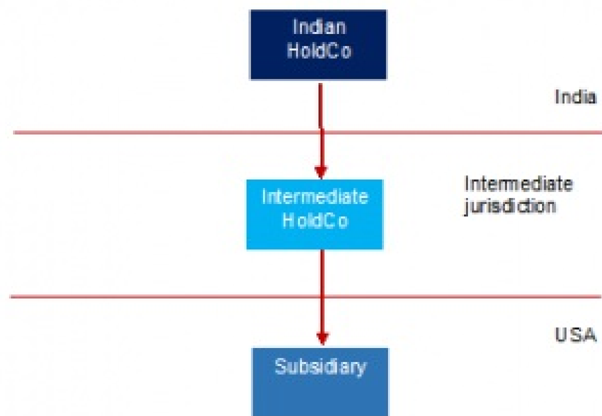

Selection of an appropriate intermediate jurisdiction is essential to optimize the income tax benefits expected to flow from such operations. For U.S. purposes, the intermediate HoldCo must meet a limitation on benefits provision in the treaty between the U.S. and its country of residence. Typically, the Intermediate HoldCo is placed in a jurisdiction where active business operations are carried on that are similar or related to those in the U.S. The essence is to avoid double tax leakage and to optimize cash flows for the purpose of making investments outside India, from such intermediate jurisdiction.

Dividend or capital gains income from the intermediate jurisdiction may be received at a NIL or lower withholding tax, based on the provisions of the Indian treaty with the intermediate jurisdiction. It is also important to consider other provisions of such a treaty, e.g. limitation of benefits, underlying tax credit or tax sparing.

Transactions between the Indian HoldCo and the foreign entities will have to be in compliance with transfer pricing provisions.