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Doing Business in India

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Peter Trieu and Brian Rowbotham co-authored "Doing Business in India," which was published in the May/June publication of the California CPA. S.R. Mehta, Chartered Accounting Firm in Mumbai, also provided commentary about business structures and tax rates that generally apply to companies operating in India.

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<< Doing Business in **India** >>

BY PETER TRIEU, Esq. and BRIAN ROWBOTHAM, CPA

Foreign investors will find immense opportunities in India given that the country is rapidly industrializing and government policy welcomes foreign participation in almost all sectors. And with 20 cities boasting populations of at least 1 million and a total population of more than 1 billion, India is one of the largest markets in the world.

A series of economic plans is fostering India's considerable economic development, transforming its economic landscape and assisting the country's rapid industrialization. A world leader in information technology solutions and services—thanks to its large pool of skilled IT professionals, trained engineers and technicians—it is no wonder that we have seen manufacturing, processing, assembly, high-tech development and other activities shifting to India from the United States over the past several years.

Forms of Investments in India

Foreign direct investment, foreign institutional investment and foreign venture capital investment are the three primary forms of investing in India. As the latter two are typically passive, foreign direct investment is usually the choice of an active business wishing to expand into India.

India encourages foreign direct investment by making the process rather straightforward. With respect to most activities, such investments can be made by a resident outside India (other than a citizen of Pakistan) or by an entity incorporated outside India (other than an entity incorporated in Pakistan) by simply informing the Reserve Bank of India. No prior regulatory approval is needed.

Note, however, that investing in the following sectors does require government approval: activities in which a foreign partner has an existing joint venture in India, acquisition of shares in an existing Indian company in the services sector and activities outside the notified sector policy/capital limits.

Foreign investors may establish a business presence in India using any of the following forms:

- Joint venture with an Indian partner and/or by making a public offering;
- Incorporating with 100 percent foreign equity; or
- Opening branch offices for business activities of overseas parent companies or to serve as liaison offices. The foreign investor must obtain the permission of the Reserve Bank of India in either case.

Foreign investors not wishing to have any participation from the public will prefer establishing a private company, which can easily be converted into a public company should the desire for public investment arise.

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Establishing a private limited company is the typical route for U.S. companies expanding into India. This form allows a great deal of flexibility in that it can be wholly owned, established as a subsidiary, structured through a Mauritius holding company (see below) and may be taxed as a pass-through entity in the United States.

Operating a business in India through a branch is generally unappealing because it gives rise to complex reporting obligations and opens the business to Indian taxation on effectively connected income and non-Indian source income. A branch also is subject to higher taxes.

Foreign corporations may also operate in India under their foreign charters. Within a month of establishing business in India, however, the corporation must register with the Registrar of Companies.

Tax Regime

Residential status determines the taxability of an entity in India. As in the United States, resident taxpayers in India are taxed on worldwide income. Nonresidents are taxed only on income connected with a business in India. A company incorporated in India is an Indian tax resident. Other corporations are also treated as residents of India if management and control occur entirely in the country. Domestic

trigger a deemed dividend from a foreign subsidiary to the U.S. parent company even if not remitted. While inter-company balances, such as receivables and payables, are a common practice with a domestic consolidated group of companies, the Subpart F rules may create significant U.S. taxes due to the deemed dividends represented by such loans and inter-company balances.

Moreover, transfer pricing between affiliates may generate a potential 40 percent penalty on tax assessments if the U.S. companies fail to maintain contemporaneous documentation to support such transactions. These complexities should not restrain anyone from pursuing foreign business opportunities, as they can be handled by the right professionals to avoid the punishing penalties and

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companies are taxed at 37.5 percent, while foreign companies and their branches are taxed at 42.5 percent. No capital gains tax applies to certain qualified investments sold on the Indian stock exchange that are held for more than 12 months. A securities transaction tax of .125 percent must be paid on the transaction value. While shareholders pay no tax on dividends received, the corporation must pay a dividend distribution tax of about 17 percent upon distributing the dividend. Interest income is taxed at ordinary rates.

Since the corporation pays the dividend distribution tax, there is some question whether the tax paid on remittance of dividends may be offset with a foreign tax credit. General analysis of creditable taxes indicates that the foreign tax credit is available, but the IRS has yet to rule on the matter. This argument is bolstered under the U.S.-India Income Tax Treaty, which provides that tax paid on dividends received by a U.S. corporation owning at least 10 percent of the Indian corporation may receive a foreign tax credit for those taxes.

The treaty does not exempt capital gains tax on sale of shares in an Indian corporation. India and Mauritius, however, have a tax treaty with the primary benefit being that capital gains are not taxed in either country. For this reason, investments through a Mauritius holding company in India are frequently made. The structure normally involves a U.S. parent company with a Mauritius subsidiary owning the Indian subsidiary. Care must be exercised to insure that effective management of the Mauritius company is outside of India to ensure benefit from the treaty.

U.S. Implications of Foreign Investments

U.S. reporting requirements of foreign transactions are rather complex. Automatic penalties may be assessed for failing to file or late filing of various IRS forms. Such penalties and forms range from information disclosures regarding a particular transaction with a foreign entity to disclosures of foreign holdings or simply a foreign bank account.

U.S. investors in foreign corporations must also contend with the Subpart F provisions (IRC secs. 951-960). These rules often

allow the enterprise to benefit from markets like India's. However, additional complexity should be factored in to one's budget since the costs of initially setting up business in India can be significant, as multiple entities may be involved in creating a tax efficient structure.

For U.S. tax reporting purposes, regulations were adopted in the United States in 1997 regarding entity classification. The default rules for foreign entities provide for corporate treatment of a foreign entity (i.e., no pass-through reporting like a partnership) if all the owners have limited liability. An election can be made by "checking the box" on IRS Form 8832 to override or change the status of the entity to avoid uncertainty regarding tax status in the United States. The election is unavailable for *per se* entities listed in the regulations. Indian private limited companies are not *per se* corporations.

Conclusion

India is a formidable marketplace for investments in the high-tech sector and others, and the demographics of the nation and the highly skilled population facilitate the ability to foster such investments. The relative ease of entering India, coupled with an ability to structure a tax efficient investment, make India even more attractive.

Tax advisers in India should always be consulted when a U.S. enterprise forms a new business there, since effective tax planning can only be implemented when the tax rules in both countries and the U.S.-India Income Tax Treaty are integrated. Coordinated planning with the necessary professionals is necessary to insure a good result. CPA

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