Indian Americans setting up companies in India? Watch out for US tax law

For a decade now, India has been a growth center and this has attracted companies and individuals alike to set up ventures in India. In the past few years, several Non Resident Indian (NRI) entrepreneurs have successfully set up companies in India and the trend is only likely to continue.

At the same time, here are some important facets of the US tax law that you must not forget.

"Ownership by US citizens, residents or green card holders in a foreign company can attract provisions of subpart F income as well as certain reporting requirements such as Form 5471, FBAR etc. Most entrepreneurs do not plan keeping these in mind and end up facing complications later on," says Vinay Navani, a CPA and director of tax at New Jersey based firm Wilkin & Guttenplan, PC.

So let's look at what you need to know before starting up a company in India.

One: Is your company a Controlled Foreign Corporation **(CFC)?**

Generally, the earnings of foreign corporations are not taxed in the US until the foreign corporation repatriates its earnings through the distribution of dividends. There is, however, an exception. If the foreign corporation is a Controlled Foreign Corporation (CFC), a different set of rules applies. For starters, the CFC will not automatically get exemption from taxation in the US on income earned in India.

So the first thing you need to check is whether the company you set up in India is a CFC. Broadly put, a foreign corporation is a CFC if on any day during the foreign corporation's taxable year, either more than 50% of the combined voting power of all classes of stock, OR more than 50% of the total value of the foreign corporation is owned by US shareholders.

A US shareholder is defined as a US corporation, partnership, citizen or resident, or US estate or trust, owning at least 10% of the total combined voting power of all classes of voting stock of the foreign corporation. US shareholders don't have to be related to each other.

It is important to understand these definitions clearly so that the shareholding can be planned efficiently. Navani explains, "For instance, an Indian Pvt Ltd owned equally by 11 US people is not a CFC but if it were owned equally by 10 US people it would be a CFC."

"Generally, a CFC by default gets taxed in the US on any net earnings earned in the foreign country even if those earnings are not repatriated. That is, the 'current' earnings

are taxed even if there is no dividend declared from the CFC. This is called subpart F income" explains Rahul Ranadive, a Florida based tax attorney.

The good news is that there are exceptions to subpart F income (we will see them in the next point.) But remember, they can be complex. "Before you set up your company, your first attempt should be to see if you can avoid CFC status completely. You can do that with some smart planning and arrange ownership in such a way that it does not attract CFC status. For instance, if you are starting up a company in India, you might consider having one or more relatives or business colleagues from India to hold 51% share holding. That way, you hold 49% and the company does not qualify as a CFC for US tax purposes," Ranadive says.

Of course, it may not be feasible from a business perspective to have a joint holding with someone from India. In such cases, we need to look at how you can qualify for the subpart F exceptions after becoming a CFC.

Two: How can you qualify for subpart F exceptions?

There are 5 types of companies that fall under subpart F income such as income from oil companies, shipping companies, foreign personal holding companies, foreign base company sales and foreign base company services. Each type of company has its own set of exceptions.

For the purposes of companies set up in India by Indian Americans, the two most prevalent types are 'foreign base company sales income' and 'foreign base company services income.' In this article, we will focus on these two.

A typical example would be an Indian American setting up a software or ecommerce business in India or a call center in India. These activities generally fall under the purview of foreign base company sales or foreign base company services income, as the case maybe.

"For the Sales income category, an exception called as the 'same country exception' applies where the product is manufactured in the same country as the selling CFC. So, an Indian CFC manufacturing a product and selling such product in India qualifies for Subpart F exclusion under same country exception. For Services income, there is no same country exception for sales of services. That is, an India CFC selling services to Indian customers does not get an exception for Subpart F income purposes," Ranadive explains.

"Many times we see cases where an Indian American has started a company in India for genuine reasons but because he is unaware of the complex CFC and subpart F rules, might end up making a mistake in either or both of the ownership or operations of the Indian corporation which proves costly," Ranadive adds.

Navani makes another important point, "If the company is set up in India and sells its products and services only within India, that qualifies as an exception. So if you set up a

company in India that manufactures software, and sell to say countries in Asia such as Singapore or Indonesia, you might attract the subpart F provisions."

Three: What reporting would you need to do?

If you have a business in India, in addition to the subpart F rules you would also attract certain reporting requirements.

i) Form 5471

You must file Form 5471 if you are a US resident, green card holder or citizen and if:

You are an officer or director and own 10% or more of the stock in a foreign corporation in the current year (Category 2)

You are not necessarily an officer or director but acquire stock in a foreign corporation in the current year to own 10% or more during the year (Category 3)

You dispose of stock in a foreign corporation the current year to bring your shareholding to 10% or less (Category 3)

You own more than 50% of the vote or value of all shares in a foreign corporation (Category 4)

You own an interest in a Controlled Foreign Corporation - CFC (Category 5)

ii) Form TD F 90-22.1 – FBAR

You must file the FBAR if you are a US resident, green card holder or citizen and have either financial interest or signature authority over a bank account overseas. For instance, if a US person owns more than 50% of an Indian Pvt. Ltd., then he or she must file an FBAR since he or she has a financial interest in the bank accounts maintained by the Indian Pvt Ltd.

iii) Form 926

"If you invest or transfer at least $100,000 to a foreign company, you must file Form 926 in the year you make the transfer or acquire 10% of stock in a foreign corporation," Navani says.

The Subpart F rules can be complicated and the purpose of this article is only to make you aware of the existence of such rules. Do consult an expert before you take decisions.

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