NRI INVESTORS: Your Way through Investment Options & a Maze of Rules

NRIs are in a dilemma as they need to close their PPF account or earn a measly 4%pa. How to handle bank and demat accounts? If you are a US resident/person, you need to be careful when investing in mutual funds and ULIPs even if you are allowed to do so. Know what is the US SEC's stand on US resident/person investing in Indian mutual funds. A comprehensive analysis by Raj Pradhan

Public provident fund (PPF) was a popular investment product for non-resident Indians (NRIs) as it provided safety of principal and decent return, along with being tax-free in India. NRIs have been putting their hard-earned money into this product. The government sent NRIs into a tizzy by making an abrupt change to lower the interest rate for NRIs to a mere 4%pa (per annum), effective 3 October 2017. A game-changing rule from the government has debarred NRIs from investing in PPF and National Savings Certificates (NSC) with effect from the same date.

Once you become an NRI, you will no longer be eligible for the current interest rate (of 7.6%) for PPF and NSC. Under this rule, PPF and NSC will yield only savings account interest from the day the person becomes an NRI. NSC investment by NRIs will have to be encashed, or will be deemed to be encashed on the day the status of the resident changes to non-resident. The PPF notification says that the account will be 'deemed closed' for NRIs which means that NRIs can freely withdraw their existing PPF corpus.

NRIs will have to get out of PPF and NSC instead of earning a measly 4%pa interest till the maturity date of the account. In short, the government does not want NRI money in PPF, NSC, POMIS (post-office monthly income scheme) and other time deposits offered by the post-office. Read our Cover Story https://tinyurl.com/yd5lgv89 Now that PPF is no longer an attractive option for NRIs, we have listed a range of products NRIs can think of investing in. NRIs investing in India should worry about taxation and tax filing requirements in their country of residence. If the income from Indian investment does not have to be reported in your country of residence and there is no tax on it, then you have full freedom while investing in India.

You will need to check what DTAA (double taxation avoidance agreement) your country of residence has with India. It forms the framework of rules on how Indian investment is taxed in your country of residence. If you are a US resident/person, you need to be careful when investing in mutual funds (MFs) and ULIPs (unit-linked insurance policies) even if allowed to do so. A US person also includes US green-card-holders and US citizens residing in India; they have to file tax returns in the US.

NRIs investing in India should worry about taxation and tax filing requirements in their country of residence. If the income from Indian investment does not have to be reported in your country of residence and there is no tax on it, then you have full freedom while investing in India

Equity (Shares): The Reserve Bank of India (RBI) allows NRIs and overseas citizens of India (OCI)/persons of Indian origin (PIOs) to invest in the Indian equity markets under PIS (portfolio investment scheme). PIS is a foreign investment route to simplify the process of registration and investment for all foreign investors. NRIs/OCIs/PIOs can purchase or sell the shares/NCDs (non-convertible debentures) of Indian companies on the stock exchange. This can be done by following these steps:

a. Bank Account: You need an NRE (non-resident external) or NRO (non-resident ordinary) account and obtain approval for stock trading under PIS.
b. Demat and Trading Account: You need a trading account (linked to the PIS account) with a broker and demat account by any service-provider.

Many banks have started offering all the above-mentioned services at a single point which has made this process smooth. NRIs need to keep in mind the following:

- Only one PIS account can be opened for buying and selling of shares;
- Stock investment cannot exceed 10% of the paid-up capital of the company;
- Intraday trading not allowed. NRIs have to take delivery of shares purchased/sold;
- Short-selling not allowed;
- Can invest in only selected stocks as listed by RBI periodically;
- Investment can be done on repatriation as well as non-repatriation basis.

The following transactions do not need PIS account.

a. Sale of shares, which were not bought under PIS. For example, gifts, subscription to IPOs or shares bought as resident Indian, or received as bonus;
b. Fresh subscription for IPOs as an NRI;
c. Investment in MFs.

Bonds/NCDs: An NRI is eligible to subscribe to bonds/NCDs issued in India. However, the issuer should specifically enable the 'NRI Window' in an offer. The bonds can be tax-free bonds or taxable. They can be subscribed on both, repatriable and non-repatriable, bases. NRIs can apply for these bonds through their NRE/NRO accounts. To apply on a repatriable basis, you need to fund it from an NRE account. For non-repatriable basis, apply from an NRO account.

Exchange Traded Funds (ETFs): Investment can also be done in ETFs available in India with your PIS account through your NRE/NRO bank account. But investors from the US may want to avoid buying ETFs as they are considered PFIC (passive foreign investment company) discussed later in this article. Even investment in shares of companies considered as PFIC should be avoided by a US resident/person.

Why a US Resident/Person May Avoid Indian MFs

An NRI, who is knowledgeable about stocks and has time to research the same, may invest directly in stocks. It may not be practical for most of the NRIs who are busy in their work and life or have no knowledge about stocks or how to do research or valuation. For them, equity MF could be the only option. Many developed countries (unlike US) do not levy tax on notional income but only on realised income, i.e., in the year of selling MF. NRIs need to understand the implications of investing in MF schemes or stocks in India.

NRIs in countries other than US and Canada can continue to invest in Indian MFs subject to understanding the taxation and tax compliance rules in your country of residence. What about US and Canada residents? Once you declare the country of your residence to be US or Canada to Indian fund houses and fill the form under Foreign Account Tax Compliance Act (FATCA), some AMCs (asset management companies) may not allow future investments. This is mainly due to regulatory restrictions from Securities Exchange Commission (SEC) of the US. None of the Indian AMCs is registered with SEC. Read our Cover Story - https://tinyurl.com/yar7hbdq There are a few AMCs like UTI, Reliance, etc, that will accept business from you even if you are a US/Canada resident/person.

There is news of more MFs making their schemes available for US/Canada resident/persons. Even chartered accountants (CAs) and investment advisors from India are encouraging NRIs to invest in Indian MFs. Even though none of the Indian AMCs is registered with US SEC, can you, as a US resident/person invest in Indian AMCs if allowed by them? Will there be an issue raised by US SEC? A dedicated *Moneylife* subscriber Rahul Chivate wrote to US SEC to get the answer from them. It may surprise you. The response was from Senior Counsel, Office of Investor Education and Advocacy, US SEC.

US SEC is actually fine with a US resident/person investing in Indian AMCs. Their reply states: "U.S. investors may invest in foreign mutual funds. However, such investments may subject investors to higher investment risks. In addition, income and capital gains generated from such investment are subject to U.S. tax law. For general information of investing in foreign securities, please review our publications at: https://tinyurl.com/y7ugor2t and https://tinyurl.com/ybzjmcun"

So, US SEC does not have an issue and, in India, the Securities and Exchange Board of India (SEBI) is also fine with Indian AMCs offering products to a US resident/person. In NRI forums discussing investments, there is a high attraction for investment in India, fuelled by investment advisors and MF distributors being gung-ho about NRIs investing in Indian AMCs. But, if you are a US resident/person, you may want to avoid investment in Indian MFs. Why so? Taxation and tax compliance is a major issue. If you are an NRI who is a resident of country other than US, you need to check the rules of that country for investment in MFs or other financial products in India.

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Indian MFs Are PFIC in US

As per US taxation laws, a foreign corporation is a PFIC if it meets either the income or asset test described below. The below-mentioned two clauses ensure that Indian MFs get termed as PFIC.

- Seventy-five per cent or more of the corporation's gross income for its taxable year is passive income, which is based on investments rather than standard operating business. All mutual funds (including bond mutual funds) qualify as a PFIC as their sole purpose is to generate income from investments in companies rather than through an operational business.
- At least 50% of the average percentage of assets held by a foreign corporation during the taxable year are assets that produce passive income or that are held for the production of passive income.

PFIC Taxation Prevents Tax Deferment

Dividends from MF investments are tax free in India, but will have to be added to income in US and tax calculated thereon. Handling the taxation of capital gains from Indian MFs gets complicated for a US resident/person due to tax treatment and classification of foreign MFs as PFICs. According to the PFIC rules, any notional gains from MF or private equity fund holdings must be declared every year and tax must be paid on such notional gains.

Mark to Market: Investment in Indian MF schemes with a growth option can perpetually defer taxation until redemption by investors. Long-term equity schemes are tax-free in India. Long-term debt schemes can use double indexation to reduce gains to zero or near-zero. So, Indians are lucky to have such features available to save on taxes. But, if you are a US resident/person, the luck does not apply to you.

As per PFIC rules, a US resident/person will have to declare gains from MF investment every year (mark to market) and pay taxes on it. With 'mark to market' method, you pay taxes on the difference between the value of your investments at the beginning of the year and the value of your investment at the end of the year.

Excess Distributions Method: US residents/persons wanting to avoid 'mark to market', can go with 'excess distributions method' (default method) but that will end up with much higher taxation. The net effect can possibly be effective taxation of 35%-50% or more. Taxation on PFICs is punitive compared to the tax treatment of MF schemes offered by US companies. The 'excess distributions method' option of PFIC tax rules will treat all income (including capital gains) as ordinary income taxed at the current highest individual tax rate plus compounded interest for deferred taxes for each year that you have held the investment.

A US resident/person investing in Indian MFs can get caught between devil and the deep sea. But do AMCs, CAs or financial advisors really tell you about it? They are not considering US taxation and tax filing. Just because the US SEC is fine with investments in Indian MFs, it does not mean that you should jump into it. US SEC response clearly states: "Income and capital gains generated from such investment are subject to U.S. tax law."

Jigar Patel, non-practising Certified Public Accountant (CPA from US), CA (India) and partner at Naresh J Patel & Co, says, "It is important to understand the concept and reason for the default option, i.e., excess distributions method. If you buy a mutual fund in January 2015 and sell in February 2018, the gain is not of 2018 but of four years (2015, 2016, 2017 and 2018) and the gain is to be recognised in the respective years. If you do not report the income in the respective years, you would need to pay the tax with interest in the year of selling the fund. Because of the interest on previous year's taxes, it becomes expensive to select the default option."

Qualified Electing Fund Method (QEF): This is an excellent option wherein a foreign MF, which is allowed QEF option, is taxed just like any other US MF. For it to be allowed, the PFIC needs to meet certain accounting and reporting requirements. But none of the Indian AMCs is registered with SEC and it is unlikely that they would report information the way US MFs would do to SEC. So, an Indian AMC qualifying as QEF is unheard of. Effectively, US residents/persons investing in Indian AMCs will not qualify for the QEF method; hence, they may like to avoid investing in Indian MFs.

CA Patel adds, "It would not be practical to select QEF for Indian mutual fund as a unit holder of a QEF needs to annually include its *pro rata* share of the ordinary earnings of the QEF as ordinary income and its *pro rata* share of the net capital gain of the QEF as long-term capital gain. In India, there is no information sharing with the investor for his/her share of earning and / or capital gain and it would not be possible for an investor to find out this information especially when the *pro rata* share keeps on changing based on investment in the same fund by him and/or by other investors."

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> - Jigar Patel, non-practising CPA (US), CA (India) and partner at Naresh J Patel & Co

How PFIC Mark to Market Impacts Your Equity and Debt MFs

According to CA Patel, "I think the Mark to Market option is better for US residents. However, we do not make decision for our clients. We provide all the information about the investments, valuation, transaction details and other information required for making a declaration and calculation of gain in an Excel file and ask the clients to consult with their CPA about reporting the assets and income. We have seen different treatments being advised by different CPAs for different clients."

The growth option of investment in Indian debt MF schemes is a good option due to the twin features of tax deferral until redemption and double indexation.

Deferred tax will be almost impossible for a US resident/person, as per US rules. They will have to pay tax in the US for the calculated gains during the year, even if they do not redeem. We suggest US residents/persons avoid it due to the mark to market or excess distributions method. The tax filing is also cumbersome for investing in a PFIC.

CA Patel articulates the case for debt MF scheme investment. He says, "Debt mutual fund may be a good idea as the income is calculated in USD or foreign currency, i.e., they will get the benefit of rupee depreciation on the principal amount. For example, if an NRI from US invests 63,00,000 ($100,000 @ 63/$) in NRE FD @ 7% for one year, he will earn Rs4,41,000 as interest. If exchange rate is 65/$ after one year, he will include $6,785 as interest income. However, if he invests in a liquid/debt scheme that generate 7% return, his US$ income would be $3,708 [$103,708 (67,41,000/65) - $100,000], reducing US$ income and accordingly tax liability significantly. This is assuming that the rupee will depreciate, which has been the case in long term."

The same rule applies to equity MF schemes with growth option. Even though long-term capital gains on equity MF schemes are tax-free in India, they are taxable in the US. As per DTAA rules, if a US resident/person does not pay taxes on equity MFs in India, there is nothing to offset it when filing US tax returns and, hence, they are taxable in US (usually 15%). Mark to market will ensure that gains, even if there was no redemption, will have to be shown in US tax returns. Equity MF schmes can also have losses on paper (no redemption). So, each year's gains or losses have to be calculated to pay taxes correctly.

For mark to market option, any notional gain on holding the mutual fund for the year is offered for taxation in the same year. If there is any loss, it can only be adjusted up to the fund's previous income. If there is no income, then it will be carried forward (purchase cost will not be adjusted by change in market value) to be adjusted against the future income from the fund.

PFIC Tax Filing Compliance Is Onerous

A US resident/person investing in Indian MFs can face issues while filing tax returns to the Internal Revenue Service (IRS). Filing it incorrectly, or not filing when you need to, can attract IRS scrutiny. You will have to fill the dreaded Form 8621 which is extremely complicated. The IRS offers these estimates of how long it will take some taxpayers to deal with Form 8621. Recordkeeping: 16 hr., 44 min. Learning about the law or the form: 9 hr., 56 min. Preparing and sending the form to the IRS: 14 hr., 14 min.

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You are not required to file Form 8621, if the value of all PFICs held by you is less than $25,000 at the end of the year ($50,000 if filing a joint tax return in US), and there were no distributions or dispositions during the year. But if you want to make one of the elections described above, then you need to file Form 8621. The default election is excess distributions method which has its own drawbacks.

So, if you are a US resident/person investing in

FATCA to Catch PFIC Investors?

If you have a financial interest in India and happen to be a resident of US/Canada or you are a person from US/Canada (US/Canada citizen or holding permanent residency) not residing in US/Canada, you need to be aware of the implications of FATCA. India and US have entered into an inter-governmental agreement (IGA) in July 2015 under which Indian financial institutions (FIs), including mutual funds, will provide the necessary information to the Indian tax authorities which will then be transmitted to US Internal Revenue Service (IRS) periodically.

FATCA declaration was to be collected from those investors who have opened MF folios on or after 1 July 2014 or if they have an account on 30 June 2014 wherein the value of investments is above $50,000. However, banks and brokerage firms asked for FATCA declarations only from new customers as well as old customers who had foreign address or NRE/NRO accounts.

Indian MF schemes and do not file Form 8621 for your Indian MF investment, then you have defaulted to excess distributions method in the year of sale which is not desirable.

Real Estate: Issues with Buying, Selling and Renting

Buying multiple properties in India is not efficient from the taxation perspective. Only one property can be shown as self-occupied. The other has to be rented out and rental income is taxable; if not rented out, it is considered deemed let-out and the deemed rent is taxable. Investors not showing rental income from multiple properties becomes an issue with Indian tax compliance.

Tracking of properties held by Indian residents and NRIs is difficult and, hence, real estate investors have always been flying under the radar of tax authorities. NRIs/PIOs/OCIs are big investors in Indian real estate; they have to worry whether FATCA will apply to real estate holdings in future. The issue, again, is that income from real estate may not have been reported in the US tax returns and, hence, NRIs may not want to reveal that they did not report the Indian rental income in US tax returns. With fear of FATCA, NRIs are trying to come clean before they get caught.

Unlike India, the foreign country may not even allow calculation of inflation indexed purchase price to lower your capital gains. If such adjustment is not allowed, your capital gains abroad can be much higher than the capital gains calculated for Indian tax laws

Property Buying Fraught with Unclear Title Issues

Real estate has been a popular investment option for NRIs/PIOs/OCIs. They are allowed to invest in residential and commercial properties with NRO/NRE accounts to make payment but cannot invest in agricultural land, farm house or plantations in India. NRIs can own such properties only if they have been inherited; but selling of such properties can be only to a resident Indian.

With the real estate market in India going through a downturn, NRIs should be wary of buying property as an investment. Moreover, buying property in India can have issues of legalities and clear titles. Do check that the property has all the required approvals from civic authorities for construction. It is not easy for a novice to buy property without hassles. Having the 'right' intermediary can help to check the documentation and do proper title search and transfer; but agents are unregistered and, hence, service levels can vary. NRIs can avail home loan from Indian banks or financial institutions after satisfying the eligibility criteria. The loan amount and repayment transactions are in Indian rupees.

Property Selling Can Trouble You with Capital Gains Abroad

Property is an illiquid asset. It is not easy to sell in a down market without taking a beating. Selling property comes with some restrictions by FEMA (Foreign Exchange Management Act), especially for repatriation transactions. The property transaction can generate a high amount of capital gains which can create taxation issues especially for NRIs, depending on the country of residence.

Taxation on capital gains in India can be avoided by buying another property or investing in capital gains savings bonds from Rural Electrification Corporation (REC) and National Highways Authority of India (NHAI). But your country of residence may not accept such an arrangement. For example, a foreign resident may save taxes on property sold in India by re-investing in property or buying such bonds. But it may not be allowed under tax laws of the foreign country where the NRI resides. The capital gains made zero in India may mean that full capital gains will have to be paid in the foreign country.

Unlike India, the foreign country may not even allow calculation of inflation indexed purchase price to lower your capital gains. If such adjustment is not allowed, your capital gains abroad can be much higher than the capital gains calculated for Indian tax laws. It is crucial to consider if the income-tax liability in the country of residence on the capital gains will nullify the tax savings you made to satisfy the Indian tax laws. You will wonder whether claiming exemption under Sections 54/54F/54EC was really the correct decision.

If you end up saving taxes in India, but paying in your country of residence, your tax saving may not materialise. The NRI may be better off claiming only partial or no tax savings at all in India. Buying property in India may seem unattractive when you consider the tax angle in your country of residence. So, don't jump into buying property without knowing the tax issues when you exit.

NRI Investments and Taxation

Jigar Patel is the author of *NRI Investments and Taxation: A Small Guide for Big Gains*. He is CFA (USA), MBA-Finance (USA) and CA (India) who is partner of Naresh J Patel & Co. He had CPA (USA) licence when he was staying in USA, but is no longer allowed to practise as a CPA. Here are some tips for NRIs given by him.

1. **Know yourself.** NRIs should know their risk profile, return expectations, tax slab, investment portfolio, diversification, investment objectives, liquidity, family situation and circumstances, time horizon, compliance requirements, etc, before investing in India.
2. **Understand that the FEMA (Foreign Exchange Management Act) and Income Tax laws are different.** NRIs should know FEMA rules as the FEMA guides about what, when, why, where, when, how much an NRI can invest in India and/or remit funds outside India. The Income-tax Act only determines the tax liability of any income generated from investments made as per FEMA laws.
3. **Consider foreign currency risk:** The rupee has long history of depreciation and is also expected to depreciate in future due to difference in inflation, interest rates and other factors. While the rate of depreciation may change in short term, in the long term, it will be about 3%-4%pa. So, Invest in India only if you are ready for the currency fluctuations and are ready to take about 3%-4%pa currency risk.
4. **Keep investments simple and in instruments that you understand.** The purpose of any investment needs to be defined whether for risk minimisation (protection) or for return maximisation (growth). Don't mix protection with growth or vice versa. It is very easy to give complicated solutions to simple problems but it is very difficult to offer simple solutions for complex problems.
5. **Understand and comply with all laws.** Don't take any short cuts. If someone asks you to do something, please understand the reasons behind it, whether it is for compliance or making your/ their life easy. For example, many NRIs were and are still being told to get Aadhaar card due to ignorance or to circumvent the laws; however, NRIs are not allowed to have Aadhaar card and Aadhaar card is not required if the account/ investments are owned properly, i.e., as non-resident. Compliance is the key for investments by NRIs. I expect the compliance requirements to increase and/or implementation to become more strict in future; so better to plan and comply. If you can't do it on your own or your agent or relationship manager is not equipped, work with a knowledgeable and experienced adviser.

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Property on Rent – Is Tax Deducted at Source?

Renting your property with a 'leave and licence' (L&L) agreement can be better than giving your property without any paperwork. Registering and paying stamp duty on the L&L agreement can ensure your right as the owner. The police can help you as the property owner if you have registered L&L agreement. If you don't have an agreement, it may be tougher to get justice.

Power of Attorney (PoA): When you are an NRI, you have the additional burden of giving a PoA to one of your family members to execute the L&L agreement, in your absence. You may not be able to personally meet the licensee to know him/her before renting It is a disadvantage. There is always fear of the licensee not vacating the place, despite signing an L&L agreement and registering it.

TDS on Rent: Under L&L agreement, a licensee is required to deduct tax at source at 30.9% under Section 195 before making the balance rental payment to the NRI owner. The licensee needs to pay the rent directly into the NRO account. The TDS by L&L licensee can be a turn-off for both parties, even though the owner is liable to be taxed on the rental income and can even get a refund if the income from Indian sources is below the minimum slab rate.

Good Old NRO/NRE Fixed Deposits

NRIs, PIOs/OCIs will usually have NRE or NRO account. Resident bank accounts opened before moving abroad will have to be converted to NRO accounts. It is better to do the conversion to NRO account before moving abroad as it will require greater efforts to do so when you are out of India.

NRIs can buy term plans; some insurers may not accept proposals from PIOs/OCIs. Medical tests are usually done in India. It should be possible to get them done abroad too, if the insurance company allows it. LIC's online term plan, e-Term, can be purchased by NRIs, but it is not offered to PIOs/OCIs

NRO Savings and FDs

When you become an NRI, you will need to convert your savings account and fixed deposits (FDs) to NRO savings and NRO FDs, respectively. Interest earned on NRO account is taxable and also subject to TDS. The TDS for NRO accounts will be 30.9% instead of 10% for resident Indians. Even NRO savings account interest will be subjected to 30.9% TDS; resident savings account has no TDS. To have lower TDS for NRO accounts, you will need to submit TRC (tax residency certificate) from the country of residence. For example, DTAA allows TDS of 15% for US residents submitting TRC for their NRO accounts.

NRE Savings and FDs

You can open NRE account for putting money you earn abroad (if you do not wish to keep it in your country of residence). NRIs, PIOs/OCIs are permitted to have NRE accounts with Indian banks. When you convert your foreign currency to Indian rupees to put in NRE account, you are subject to currency conversion risk. Interest earned on NRE account is tax-free in India, but it may be taxable in your country of residence.

For NRIs from countries that do not tax on the Indian income (e.g., UAE, Kuwait, Qatar, etc), NRE FD is the best investment option for risk-free return. However, However, for NRIs from US or other developed countries that tax foreign income, NRE FD interest can be taxable, for example, NRE interest is taxable in US.

NRE principal and interest amount can be freely repatriated to your country of residence. NRE FD is a good option, but the interest will have to be added to income shown in your US tax returns. NRE FD is still a decent option as there are no worries of taxation and tax filing in India. NRE FD needs to be for a minimum one year, to earn interest.

Surprising Reason To Avoid Buying Insurance for Investment

Term Plan Is Good for NRI/PIO/OCI

Moneylife has always advocated buying a term plan for life insurance needs. At the same time, we have been clear that insurance-cum-investment products (traditional policies, ULIPs, pension plans) need to be avoided. We are giving yet another reason for NRIs from US to avoid insurance-cum-investment products. It can be considered as PFIC which increases tax burden and compliance in US.

NRIs can buy term plans; some insurers may not accept proposals from PIOs/OCIs. Medical tests are usually done in India. It should be possible to get them done abroad too, if the insurance company allows it. For example, LIC's online term plan, e-Term, can be purchased by NRIs, but it is not offered to PIO/OCI. NRIs from several countries may be accepted. Insurance companies avoid NRIs from specific countries they consider risky. Please read our Cover Story on NRI/PIO/OCI life insurance - https://tinyurl.com/yauxmmyz

Is Insurance as Investment Considered PFIC in US?

The idea of PFIC is not simply limited to MFs as it can also apply to certain individual stocks or even life insurance products. Insurance policies pay money-back or lump-sum at maturity from their earnings on investment in bonds, government securities or equities. They pool the premiums and invest them to earn income by getting interest, dividend or capital gains.

Any corpus that generates passive income and has units and NAVs can be regarded as PFIC. As per the definition of PFIC, LIC or any private insurance company's ULIP can be considered a PFIC. Endowment or money-back policy may not be considered as PFIC, even though some websites state otherwise. The jury is out on this. Don't expect insurance companies to give you any clarification. ■