How NRIs in US, Canada are taxed on capital gains from Indian MFs

The rules pertaining to taxation of income from Indian mutual funds in both US and Canada are complex

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MF taxation for non-resident Indians

The complicated rules of taxing Indian MF income in US/Canada is a significant drawback to choose MF as a preferred choice of investment for NRIs in those countries.

TAXES

NRI Capital Gains Tax and TDS rates

Equity-oriented schemes	Tax rate	TDS rate#
Long-term capital gain (> 1 year)	10%*	10%
Short-term capital gain (< 1 year)	15%	15%
Other than equity-oriented schemes		
LTCG (listed) (>3 years)	20% (with indexation)	20%
LTCG (Unlisted) (>3 years)	10% (without indexation)	20%
STCG (< 3 years)	At individual's slab rate	30%

*if it exceeds ₹1 lakh in a year **excluding surcharge
#TDS rates are subject to DTAA provisions and may vary with each individual case

Taxation in US

(India-US Tax treaty allows taking credit of tax paid in India)

Tax regime - Passive Foreign Investment Company (PFIC)

Three options to choose from

- Qualified Electing Fund route
- Mark to market reporting
- Excess distribution method (if either of the above options is not selected)

Qualified Electing Fund route
Investor's share in the capital gains earned by the fund will be treated as capital gains every year
Taxing Unrealized gains: Yes
Source of information: AMC

Mark to Market reporting
The difference between fair market value at the end of the year and the adjusted cost is taxed as ordinary income each year
Taxing Unrealized gains: Yes
Loss available to set-off and carry forward
Source of information: Mutual Fund year end statements

Excess distribution method
Take Ms X, who has ben living in the US for the past 15 years

Value of MF investment made in January 2012	$100,000
Sale value of MF investment in December 2021	$300,000

Gains $200,000
Tenure 10 years

Taxation of gains in 2021, subject to conditions

Gains allocated to each year: from 2012 to 2021: $20,000 ($200,000/10)

Taxation of gains from 2012 to 2020
Highest marginal rate for each year
Plus interest penalty for non-payment of taxes from 2012 to 2020

Taxation of gains for 2021
Treated as ordinary income -taxed at individual's slab rate

Applies to any excess distribution from PFIC or sale of PFIC units. Excess distribution is a current year distribution, which exceeds 125% of the average of last 3 years distributions

Taxation in Canada

(India-Canada Tax treaty allows taking credit of tax paid in India on pro-rata basis)

Tax treatment
50% of capital gains taxed in Canada

When
In the year of sale

Reporting of unrealised gains
For individuals with more than 100,000 Canadian dollars invested outside of Canada, detailed disclosure is required (subject to conditions)

Tax credit
Up to 50% of tax paid in India.

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Status of a few of the mutual funds in allowing investments from NRIs based in US and Canada

Offline mode requires submission of document that the investor is in India while making the investment

	US	Canada	Online/ offline mode
SBI MF	✓	✓	Offline
ICICI Pru MF	✓	✗	Offline
DSP MF	✓	✗	Offline
IDFC MF	✓	✗	Offline
Aditya Birla SunLife MF	✓	✓	Both
PPFAS MF	✓	✓	Offline
Sundaram MF	✓	✓	Both
Edelweiss MF	✓	✓	Info not available
White Oak MF	✓	✓	Offline
Franklin/Tata MF/ Canara Robeco/Invesco/Mirae/ PGIM/Quantum/HSBC	✗	✗	

Source: AMCs, Chandrika Kadur, CPA, CA, Senior Tax Manager with Petrinovich Pugh & Co, a California based CPA firm and Mo Ahmad, LLB, BA, founder of Westmark Tax Group from Canada

A non-resident Indian (NRI)—a citizen of India residing outside the country, defined as per the Foreign Exchange Management Act (FEMA), 1999—can invest in mutual funds (MFs) in India. The important condition is that one has to invest via an NRE- (Non-Resident External) or NRO- (Non-Resident Ordinary) denominated account of any bank in India.

However, rules pertaining to taxation of Indian MF income in US and Canada are complex. Also, the compliance requirements for asset management companies to allow NRIs to invest are stringent. A few fund houses don't allow such investment, while some others permit it in an offline mode with a declaration that the investor was based out of India while making the first investment.

Mint spoke to Chandrika Kadur, a senior tax manager with Petrinovich Pugh & Co., a California-based firm, and Mo Ahmad, founder of Westmark Tax Group in Canada, to decode the taxation of capital gains from Indian MFs in the hands of NRIs based in the US and Canada. Note that the tax treatment of dividend income from mutual funds is not considered herein.

When is an individual considered a US/Canada resident to comply with tax requirements?

US: It is based on the number of days an individual has stayed here—183 days is the threshold. To be considered as US tax residents, the total of all days stayed in the US in the current year, plus one-third of all days in the previous year and one-sixth of all days in the year prior to that should be more than 183 days. Green card holders are treated as residents regardless of the substantial presence test.

Canada: Individuals who are physically present in Canada for more than 183 days in a calendar year are deemed to be tax residents under the Canadian rules, subject to conditions. There is also another way to determine tax residency here, and it is based on facts and circumstances. So, let's say that an individual migrates to Canada in November this year and settles down there. From November, the individual could be considered a Canadian resident, irrespective of the number of days stayed in the country.

How are capital gains from investments in Indian MFs taxed?

US: Income from Indian mutual funds are taxed in the US under Passive Foreign Investment Company (PFIC), which has been introduced to discourage investments in foreign MFs. The related information under PFIC has to be reported in Form 8621. MF income under PFIC can be taxed via the 'excess distribution method' (default option), 'Qualified Electing Fund' route and 'Mark to Market reporting'. (*See illustration.*)

The Qualified Electing Fund route is the most preferred option, wherein the appreciation in investment value, even if unrealized, will be taxed as capital gains each year. Importantly, taxpayers need to opt for this in the very first year of filing returns in the US. Post that, choosing this option would be difficult.

In Mark to Market reporting, the difference between the fair market value of the holdings at the end of the year and the adjusted cost each year will be considered for computation of 'ordinary income', which will be taxed at individual income slab rates. Any losses can be set off against gains in this route.

The default method, which gets applicable if either of the above two options is not selected, is extremely punitive. In simple terms, the capital gains on sale of MFs could be allocated over the entire holding period and taxed in each year at the highest marginal rate applicable to that investor. Further, it also charges interest penalty considering that the taxes were not paid in the previous years.

Canada: Here, capital gains are taxable on 50% of the actual gains taxable in India. Let's say you have MF units that you sell and make $100 capital gain, only $50 is reportable in Canada as a taxable capital gain at the individual's marginal tax rate.

> **In the US, taxes are levied at both the federal and the state level; in Canada though, it depends on the province**

What are the applicable tax rates?

US: Taxes are levied at two levels – the federal level and the state level. At the federal level, the ordinary income is taxed at rates applicable to the individual tax payer, in the range of 10% to 37%. State taxes may vary from 0 to 13.3%.

Long term capital gains (LTCG) and short-term capital gains (STCG) are distinguished based on the holding period of one year. STCG is taxed as 'ordinary income' at applicable tax rate for the individual, while LTCG is taxed at either 0, 15 or 20% tax rate.

State level taxes, which are over and above the federal taxes, are decided on a case-to-case basis. Some states (eg. California) do not follow Federal treatment of PFIC. Income will not be recognized, nor taxes imposed, until a distribution is received, or a disposition has occurred. One needs to pay an extra net investment income tax rate of 3.8%, if the tax payer's gross income breaches a certain threshold.

Canada: In Canada, the applicable rates for taxing capital gains depends on the province that taxpayers live in. The highest rate of 54% is in Quebec state. In that case, the applicable tax rate will be 27% on overall gains. Because only 50% of the actual capital gains are taxable. In Canada, there is no distinction between LTCG and STCG.

Are there any tax credit provisions in US or Canada for the tax already paid in India?

US: Foreign tax credit essentially permits a US resident to offset any taxes that is paid on income in India and that is double taxed on the US tax return. To claim the foreign tax credit, one needs to file an additional form—Form 1116—along with the tax return.

Any foreign tax credit that you are unable to absorb can be carried back for one year or carried forward for 10 years.

Canada: If any tax is paid in India, whether it's withholding tax or any actual tax, you can report that as a foreign tax credit in the Canadian tax return.

Note that only a prorated amount of the tax paid in India would be creditable in Canada. Since 50% of the capital gains are taxed in Canada, only 50% of capital gains tax paid in India will be allowed for tax credit.

Is there any grandfathering clause for the gains made on investments before moving abroad?

US: There's no grandfathering clause. And when you're a US tax resident, you are subject to tax on your worldwide income. The cost of MF investments for the purpose of tax calculation in the US would be the original cost of acquisition. However, there will be no double taxation on the same income.

Canada: The cost of MF investments held in India will be the fair market value of such investments on the date of becoming a resident. That is, the capital gains made before an individual becoming a resident is not taxable in Canada.

What are the compliance requirements?

US: Some information to be filled in Form 8621 are details of MF units you own, total number of units in that MF and its value at the end of the year. Individuals could be asked to report each of their MF investments separately, providing details of underlying investments of each scheme. Sometimes, these details may not be easily available and could become a very time-consuming process.

Canada: Generally, reporting of capital gains on investments in Indian MFs is done only when the units are sold by the investor. However, sometimes, there is a requirement to do a review of the structure of the foreign holding (Indian MFs), on a case-to-case basis, to decide if the reporting is required. This could become mandatory for individuals with more than 100,000 Canadian dollars invested outside of Canada.

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