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INSIGHT: India Returns to the Conventional Regime of Taxation of Dividends

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The existing regime of taxation of dividend in India is provided in Section 115-O of the Indian Income Tax Act, 1961 (the Act), which is a special provision for the levy of additional income tax on such distributed profits, commonly referred to as dividend distribution tax (DDT), on the amount of dividends declared or distributed or paid by the Indian company. The dividend received is consequently treated as exempt in the hands of the recipient shareholder.

The existing regime of taxation of dividends has led to a debate as to whether the lower rate as provided in the Double Taxation Avoidance Agreement (the treaty) could be applied for taxation of dividends paid by an Indian company to nonresident shareholders.

The DDT, under the present law, has been treated by the Indian Revenue Service (IRS) as the tax imposed in the hands of the Indian company paying dividends and not a liability of the nonresident shareholder, and for that reason the benefit of tax treaty is denied by the tax authorities in India.

The existing regime of taxation of dividends is an obstruction for foreign investors, who in most countries are not able to claim credit for the tax paid on dividends in India.

Proposed Amendment

To overcome this, the Finance Bill 2020 propose to remove the regime of DDT on dividends declared from April 1, 2020. As per the amended provisions, dividends declared by Indian companies to shareholders would not be subjected to DDT under Section 115-O of the Act, but would be taxable in the hands of the recipient shareholders at the applicable rates.

The memorandum explaining the provisions of the Finance Bill correctly explained the spirit and nature of taxation of dividends under the existing Section 115-O of the Act, when it states that ''The incidence of tax is, thus, on the payer company/mutual fund and not on the recipient, where it should normally be. The dividend is income in the hands of the shareholders and not in the hands of the company. The incidence of the tax should, therefore, be on the recipient.''

The legal position in this regard is clarified by the Supreme Court case of Tata Tea Co. Ltd (2017) 85 taxmann.com 346, that the levy of DDT under Section 115-O of the Act pertaining to declaration, distribution or payment of dividend by the Indian company, and imposition of an additional tax on dividend and is, therefore, covered within the scope of Entry 82 of the Constitution.

What follows from the law as clarified in the memorandum is that the DDT is a tax on dividend.

The memorandum to the Finance Bill further clarified that ''the present system of taxation of dividend in the hands of company/mutual funds was reintroduced by the Finance Act, 2003 (with effect from the assessment year 2004–05) since it was easier to collect tax at a single point and the new system was leading to increase in compliance burden. However, with the advent of technology and easy tracking system available, the justification for current system of taxation of dividend has outlived itself.''

The Honorable Finance Minister, Nirmala Sitharaman, in her budget speech also stated that ''. . .the system of levying DDT results in increase in tax burden for investors and especially those who are liable to pay tax less than the rate of DDT if the dividend income is in-

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cluded in their income. . .Further, non-availability of credit of DDT to most of the foreign investors in their home country results in reduction of rate of return on equity capital for them.''

This confirms the position that DDT, though levied as additional income tax under Section 115-O of the Act on the company paying the dividend, has always been perceived by the government as a surrogate tax on the dividend income earned by the shareholders.

Consequently, when, under a bilateral treaty, the two countries agree a taxation of dividend income in the source state at 5%, 10% or 15%, charge of a higher tax at 20.36% by way of levy of DDT in terms of Section 115-O of the Act is a breach of the shared understanding in terms of the treaties, merely on the basis that a different mechanism for collecting tax on such dividend income from the company paying such dividends to the nonresident shareholders adopted by the source country. This is contrary to the principles of *Pacta sunt servanda* (Article 26) and Internal Law and Observance of Treaties in (Article 27) in the Vienna Convention.

Impact on Foreign Shareholders

Foreign shareholders who have invested in India would stand to gain from the proposed amendment of shifting to the conventional form of taxation of dividends in the hands of shareholders, as this gives them an unambiguous opportunity to take advantage of lower rates of taxes on dividends provided under the treaties.

Also, the nonresident taxpayer will be entitled to claim foreign tax credit in their country of residence as per the treaty provisions (subject to the limitation of benefit clauses).

In order to benefit from the favorable rates under various treaties, foreign shareholders would need to satisfy the beneficial ownership conditions as well as the principal purpose test contained in the treaties.

New Compliance Burden

Under the provisions of the Act, dividends are taxable in the hands of nonresident shareholders at a flat rate of 20%. The rate is further reduced to 5%/10%/15% if one were to benefit from the treaty provisions. It is mandatory to file an income tax return in cases where the tax is withheld by the Indian company at the beneficial rate prescribed in the treaty—a requirement that did not exist under the present law.

Also, after the proposed amendment, if the treaty benefit is not available to the foreign shareholder, the Indian company paying dividends can withhold tax at source under the provisions of the Act at the rate of 20% (nonresident Indian), 30% (other nonresidents and LLP) and 40% (foreign companies), increased by applicable surcharge and cess.

However, as stated above, the nonresident is liable to pay tax on dividend income at the rate of 20%, under Section 115A of the Act. Therefore, the foreign shareholder, in order to claim a refund of excess withholding taxes, will be required to file a tax return in India even in cases where tax is withheld at source at the rates prevailing under the Act.

Therefore, filing an income tax return is now mandatory for every nonresident receiving dividends from an Indian company.

Looking Ahead

As a result of the amendment, altering the regime of taxation of dividend income from DDT to the conventional regime of taxation of such dividend income in the hands of the shareholder, dividend declared, distributed and paid after April 1, 2020 will become taxable as income in the hands of the shareholders and taxes will have to be paid by them at the applicable rate.

Nonresident shareholders will pay tax on the dividend income as per the rate prescribed under the relevant treaties, which may vary from 5%, 10% or 15%, as opposed to the previous regime of the Indian company paying tax at 20.36%. This is subject to the foreign shareholder filing an income tax return in India.

The amendment will also assist Indian taxpayers who have made claims before the various appellate authorities, seeking to apply the lower rate of tax as provided in the treaties with the countries of the nonresident shareholders, to DDT already paid in terms of Section 115-O of the Act, in respect of dividend declared, distributed or paid prior to March 31, 2020, as the memorandum has clarified that the DDT was in the nature of tax paid on dividends on behalf of the shareholder.

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