



**India's shift from dividend distribution tax to taxing the shareholder:
Issues, challenges, and opportunities**
The Dbriefs Geography Updates series

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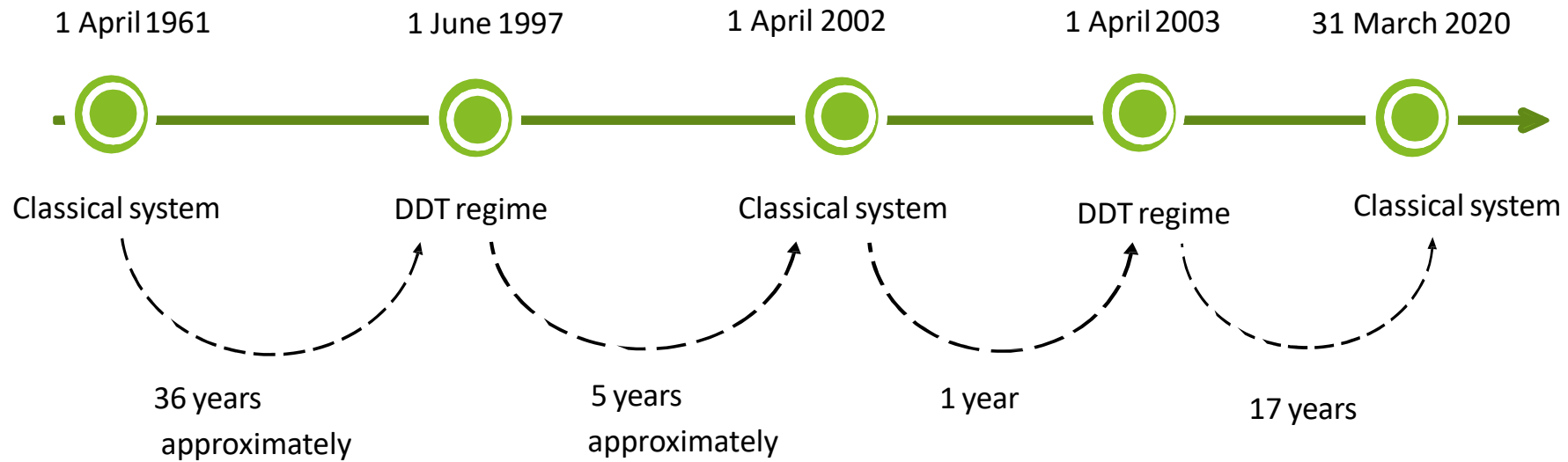
Agenda

- History of dividend taxation
- Impact on the shareholder
- Concept of beneficial owner
- Impact of General Anti-Avoidance Rules
- Impact of Multilateral Instrument
- Lower rate under Most Favoured Nation clause
- Documentation
- Questions and answers

History of dividend taxation

History of dividend taxation

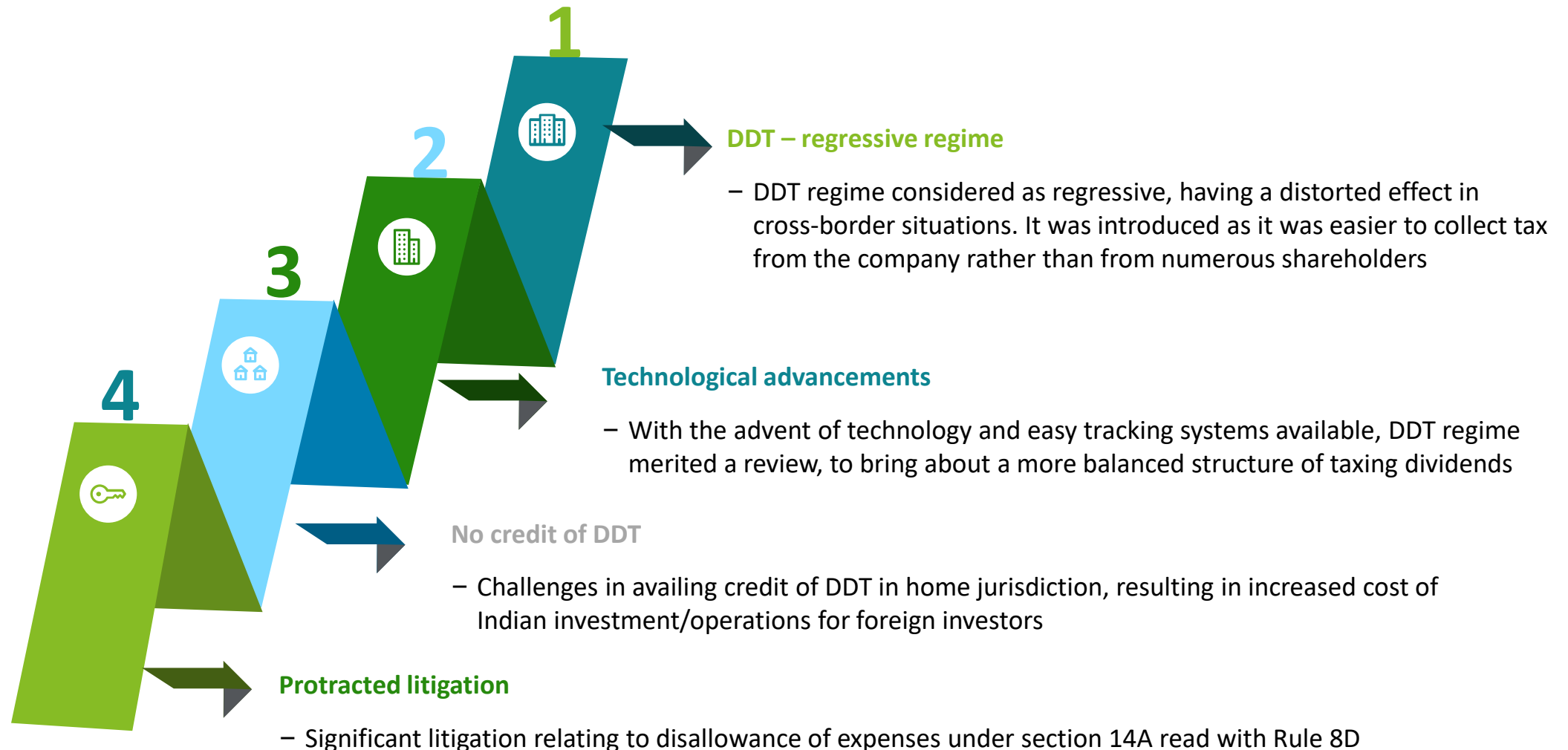
Dividend tax regime time line



| Tax year(s) | Base DDT rate (%) |
|----------------------|-------------------|
| 1997-98 to 1999-2000 | 10 |
| 2000-01 | 20 |
| 2001-02 | 10 |
| 2003-04 to 2006-07 | 12.5 |
| 2007-08 to 2013-14 | 15 |
| 2014-15 to 2019-20 | 17.65 |

History of dividend taxation

Abolition of DDT – rationale and related considerations



History of dividend taxation

Snapshot view

| Particulars | DDT regime | Classical taxation system |
|--|---|---|
| Period | <ul style="list-style-type: none">Dividend declared, distributed, received, on or before 31 March 2020 | <ul style="list-style-type: none">Dividend received on or after 1 April 2020 |
| Taxpayer bearing incidence | <ul style="list-style-type: none">Company | <ul style="list-style-type: none">Shareholder |
| ETR | <ul style="list-style-type: none">DDT – 20.56%Super rich levy –10% + SC + EC | <ul style="list-style-type: none">Applicable tax rateDTAA benefit available |
| Roll over exemption | <ul style="list-style-type: none">Available to domestic companies on dividend received from domestic subsidiary company and specified foreign companies | <ul style="list-style-type: none">Available to domestic companies in respect of dividend received irrespective of % of shareholding |
| WHT on distribution | <ul style="list-style-type: none">Not applicable | <ul style="list-style-type: none">Applicable |
| Deduction of expenditure in the hands of shareholder | <ul style="list-style-type: none">Not available in view of section 14A and section 115BBD(2) | <ul style="list-style-type: none">Available but limited by section 57 |
| MAT | <ul style="list-style-type: none">Not Applicable | <ul style="list-style-type: none">Applicable |

Impact on the shareholder

Direct investment – resident corporate shareholder

| Particulars | DDT regime | | | | Current regime (corporate) | | | |
|---|--------------|--------------|--------------|--------------|----------------------------|--------------|--------------|--------------|
| | 30%++ | 25%++ | 22%++ | 15%++ | 30%++ | 25%++ | 22%++ | 15%++ |
| Profit before tax | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Less: income-tax ¹ | (34.94) | (29.12) | (25.17) | (17.16) | (34.94) | (29.12) | (25.17) | (17.16) |
| Profit after tax available for distribution | 65.06 | 70.88 | 74.83 | 82.84 | 65.06 | 70.88 | 74.83 | 82.84 |
| Less: DDT @ 20.56% (grossed up) | (11.10) | (12.09) | (12.76) | (14.13) | NA | NA | NA | NA |
| Net dividend distributed | 53.96 | 58.79 | 62.07 | 68.71 | 65.06 | 70.88 | 74.83 | 82.84 |
| Less: applicable tax on dividend ² | NA | NA | NA | NA | (22.73) | (20.64) | (18.83) | (14.22) |
| Net dividend received by shareholders | 53.96 | 58.79 | 62.07 | 68.71 | 42.33 | 50.24 | 56.00 | 68.62 |

- Notes:**

- ¹Includes maximum applicable surcharge i.e. at the rate of 12% or 10% as applicable and education cess of 4%
- ²WHT @ 10% under section 194. However, dividend is taxable at the rates applicable based on the status of the shareholder. In the above table, we have assumed that the Indian company is taxable at the same rate at which the shareholder is liable to tax

Impact on the shareholder

Scenario analysis

- **Scenario 1:** A resident individual shareholder who has income exceeding INR 5 Crores
- **Scenario 2:** A resident company shareholder (deduction under section 80M is considered as nil)
- **Scenario 3:** A shareholder (company) which is a tax resident of Singapore to whom the tax treaty between India and Singapore would apply

| Particulars | Scenario 1 | Scenario 2 | Scenario 3 |
|--|------------|------------|------------|
| Profit after tax (entirely distributed to shareholders) | 74.83 | 74.83 | 74.83 |
| Tax on dividend payable by the shareholders Scenario 1 – maximum marginal rate for individual @ 35.89% Scenario 2 – tax in the hands of company @ 25.17% Scenario 3 – 10% as per India - Singapore DTAA | (26.85)* | (18.83)** | (7.48)*** |
| Shareholders income (Net of tax) (A) | 47.98 | 56.00 | 67.35 |
| Total tax [(100 – (A))] | 52.02 | 44.00 | 32.65 |

- In all the scenarios, it is assumed that the company distributing dividend opts for corporate tax rate of 25.17%. So, assuming that the company earns 100, post payment of corporate tax of 25.17 there would have been a distributable surplus of 74.83

Impact on resident shareholder

- **Section 57**

- No deduction other than interest expense
- Proviso to section 57 limits deduction of expenses in respect of dividend income
 - Only interest expenditure incurred in earning dividend income allowable to the extent of 20% of specified income
 - Different from disallowance under section 14A, where disallowance is of expenditure incurred in respect of income which does not form part of total income

- **Section 80M – removal of cascading effect**

- Domestic company receiving dividend income from another domestic company
- Such dividend income is included in gross total income
- Deduction is limited to the amount of dividend distributed by the dividend receiving company
- Dividend is to be distributed one month prior to furnishing of return of income under section 139(1)

• **Should the deduction of interest be on the gross dividend or net dividend income after claiming deduction under section 80M?**

Abolition of DDT

Ambiguity on quantum of dividend for claiming deduction of interest under section 57

- Dividend income is 1000
- Dividend distributed is 400

| Particulars | Scenario 1 | Scenario 2 |
|--|---------------------------------------|-------------------------------------|
| Dividend income | 1000 | 1000 |
| <ul style="list-style-type: none"> • Expenditure limitation <ul style="list-style-type: none"> – Actual interest expenditure - 300 – Dividend income qualifying for deduction under section 80M – 400 – Expenditure deduction | 200 (20% of gross dividend income) | 120 (20% of net dividend income) |
| Gross total income | 800 | 880 |
| Deduction under section 80M (equivalent to dividend distributed) | 400 | 400 |
| Total income | 400 | 480 |

- **Scenario 1:** 20% limitation is applied prior to deduction under section 80M on the gross amount of dividend
- **Scenario 2:** deduction for interest has been calculated on the basis that total income is net of deduction under section 80M. Accordingly, deduction is restricted to 20% of 600 which is after considering deduction under section 80M

Direct investment – non-resident corporate shareholder

| Particulars | DDT regime (Rs) | | | | Current regime (Rs) | | | |
|---|-----------------|--------------|--------------|--------------|---------------------|--------------|--------------|--------------|
| | 30%++ | 25%++ | 22%++ | 15%++ | 30%++ | 25%++ | 22%++ | 15%++ |
| Profits before tax | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| Less: Income-tax ¹ | (34.94) | (29.12) | (25.17) | (17.16) | (34.94) | (29.12) | (25.17) | (17.16) |
| Profits after tax available for distribution | 65.06 | 70.88 | 74.83 | 82.84 | 65.06 | 70.88 | 74.83 | 82.84 |
| Less: DDT @ 20.56% (grossed up) | (11.10) | (12.09) | (12.76) | (14.13) | NA | NA | NA | NA |
| Net dividends distributed | 53.96 | 58.79 | 62.07 | 68.71 | 65.06 | 70.88 | 74.83 | 82.84 |
| Less: Applicable tax on dividend ² | NA | NA | NA | NA | (14.21) | (15.48) | (16.34) | (18.09) |
| Net dividends received by investors | 53.96 | 58.79 | 62.07 | 68.71 | 50.85 | 55.40 | 58.49 | 64.75 |

- Notes:**

- ¹Includes maximum applicable surcharge i.e. at the rate of 12% or 10% as may be applicable and education cess of 4%
- ²WHT @ 21.84% (including maximum applicable surcharge and education cess) under section 195, subject to applicable beneficial tax treaty rate

Impact on non resident shareholder

Availability of tax treaty

- Beneficial owner

- Impact of GAAR

- Impact of MLI

- Foreign tax credit in home country

- The shareholder should qualify as a tax resident of a contracting state

Polling question 1

How will the new classical system of dividend taxation impact you?

- Lower tax in the hands of the shareholder
- Reduction in litigation under section 14A
- Removal of cascading effect
- Combination of above
- No impact
- Don't know/not applicable

Concept of beneficial owner

Analysis | beneficial owner

CBDT circular

- The Income tax Act, 1961 does not define the term “beneficial owner”
- CBDT vide circular No. 789 of 2000 issued clarifications with respect to taxation of income from dividend and capital gains under the treaty
- As per the circular, wherever a certificate of residence (TRC) is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as **beneficial ownership** for applying treaty provisions
- The circular has also been tested by various Indian courts, including the following, wherein the validity of the circular has been upheld



Azadi Bachao Andolan [2003] 263 ITR 706 (SC)



ADIT v. Universal International Music B.V. (2013) 214 Taxman 19 (Bombay High Court)



HSBC Bank (Mauritius) Ltd. v. DCIT [2018] 96 taxmann.com 544 (Mumbai - Tribunal)

Analysis | beneficial owner

Judicial precedents and OECD commentary

Principles emerging from judicial precedents w.r.t. beneficial ownership

01

- Company incorporated in tax favourable jurisdiction should be able to prove **economic, commercial, and business expediency**
- It should not be a **mere agent or nominee** working on behalf of the parent company under parent company's instruction
- It should be proved that the company **enjoys the fruits of the ownership** and has the **ability to dispose** of it for its own benefit
- The company should **have exclusive possession and control over the income** received
- The company should have **free voting power** without the control of other shareholder/ultimate common parent

Commentary on Article 10 of OECD Model Tax Convention 2017 (condensed version) deals with the term "beneficial owner"

02

- "Beneficial owner" is not used in a narrow technical sense, rather it should be understood in its context, in particular in relation to the words "paid...to a resident", and in light of the **object and purposes of the convention**
- In examples of agent, nominee, conduit company **acting as a fiduciary**, the direct recipient of dividend is not the beneficial owner because the recipient's right to use and enjoy the dividend is **constrained by a contractual or legal obligation to pass on the payment to another person**
- Hence, where the recipient of dividend has the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient could be said to be beneficial owner of that dividend

Impact of General Anti Avoidance Rules

Analysis | GAAR

Construct of the Indian GAAR provisions

- **Applicability of GAAR** (w.e.f. 1 April 2017): “... an arrangement entered into by an assessee may be declared to be an **impermissible avoidance arrangement** and the consequence in relation to tax arising therefrom may be determined subject to the provisions of this chapter.”



Elements of Impermissible avoidance agreement (IAA)

- Main objective of obtaining tax benefit (including intangible benefits)
 - Creates rights and obligations not normally created in arm’s length transactions
 - Results in direct or indirect misuse or abuse of the provisions
 - Lacks or is deemed to lack commercial substance in whole or part
 - Is not **bona fide**



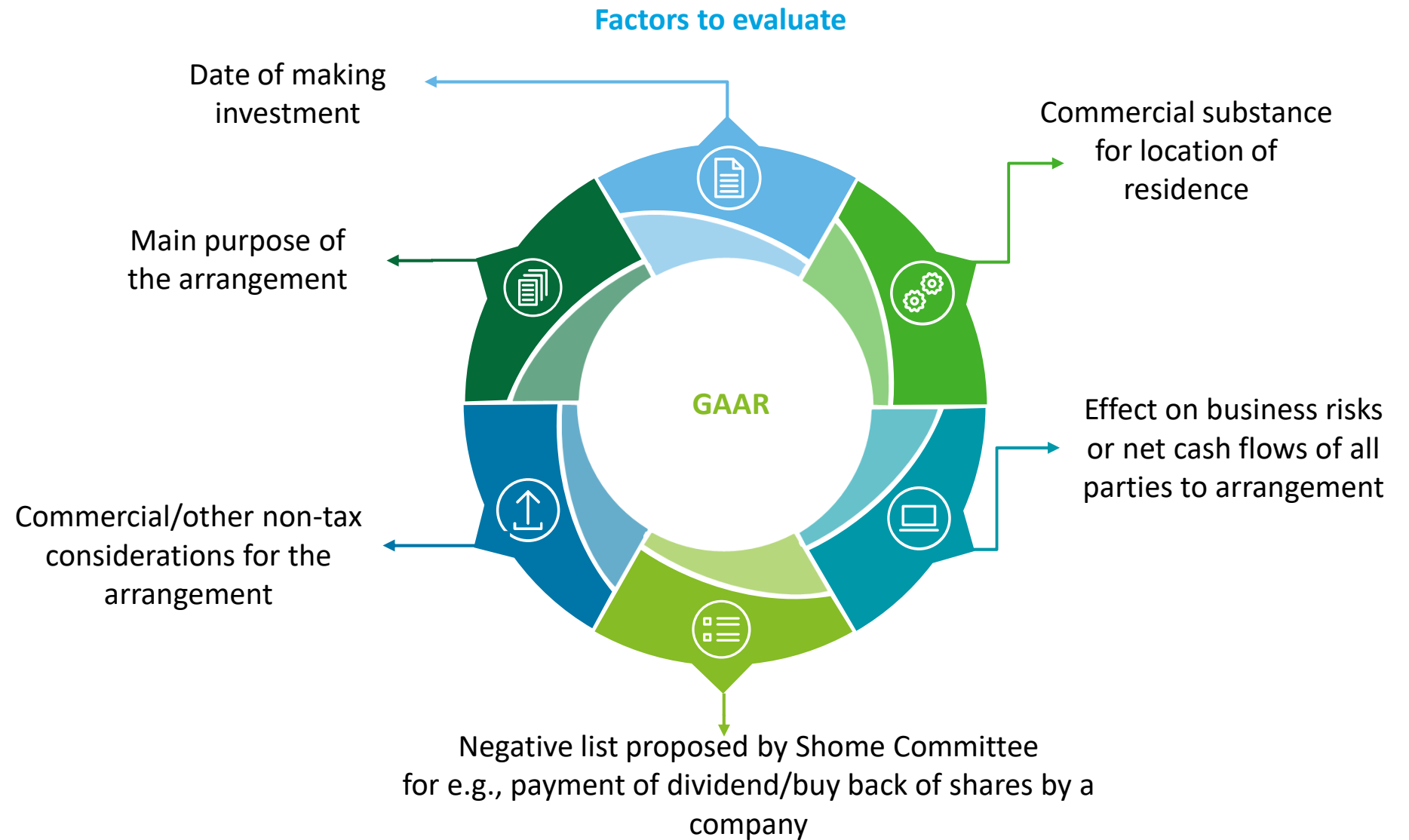
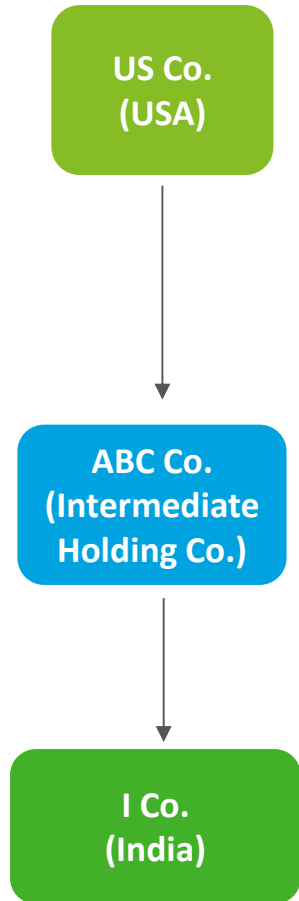
Consequences of IAA

- Disregarding, combining or re-characterizing the whole or part of the arrangement
- Treating the arrangement as if it has not been entered into
- Disregarding any party or treating parties as one and the same person
- Deeming connected persons to be one
- Reallocating any income/receipt and expenditure/deduction
- Determining the place of residence or situs of asset or transaction
- Disregarding any corporate structure
- Treatment of equity as debt and vice versa

- The provisions of GAAR do not apply to an arrangement where the tax benefit in the relevant year, arising in aggregate to all the parties to the arrangement, does not exceed a sum of INR 30 million. Income from the transfer of investments made before 1 April 2017 is grandfathered i.e., shall not come within the purview of the aforesaid provisions
- Government has issued certain clarifications/exclusions w.r.t. applicability of GAAR which need to be analyzed on a case to case basis

Analysis | GAAR

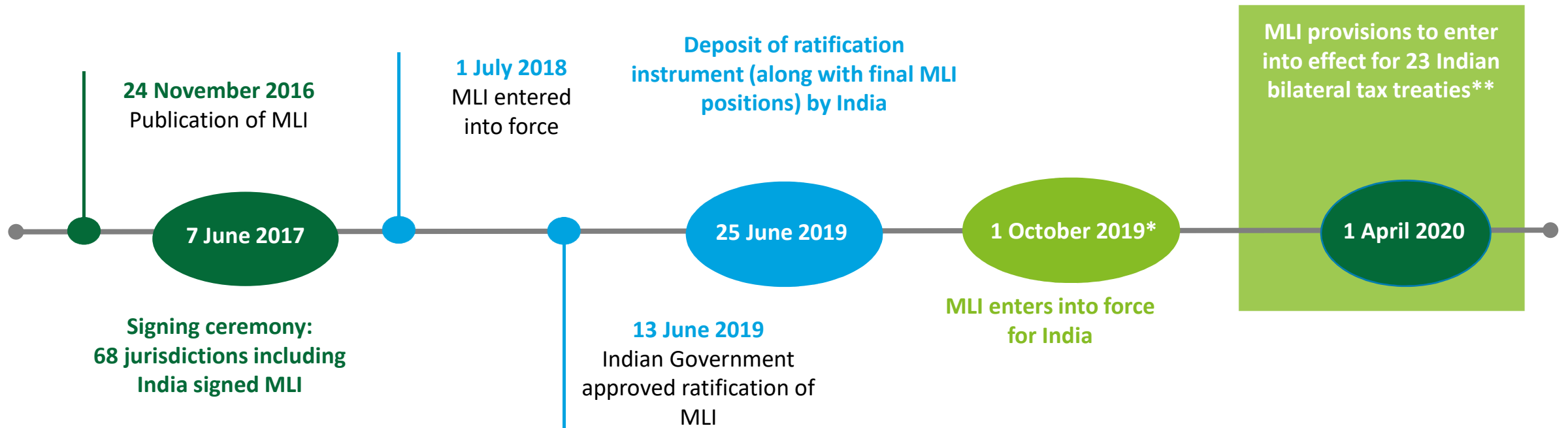
Case study



Impact of Multilateral Instrument

MLI: overview

Story so far



- *On the first day of the month following the expiration of three months beginning the date of deposit of ratification instrument by India with the OECD Secretariat
- **Indian tax treaties with jurisdictions that have already deposited their ratification instrument with the OECD Secretariat latest by 30 June 2019 and have notified tax treaty with India as Covered Tax Agreement (CTA)

MLI: overview

Modifications with flexibility and minimum standards



- MLI **modifies the operation** of existing tax treaties between parties
- None of the bilateral double tax treaties will be amended separately
- MLI and tax treaty have to be read together

- Each party to the MLI specifies the existing treaties to which the MLI applies (CTAs)
- For a specific bilateral tax treaty, MLI would have effect after both parties to a CTA have deposited their ratification instrument with the OECD Secretariat

- **Mandatory** to comply with minimum standard
- **Choices** to apply optional and alternative provisions
- **Reservations** to opt out of provisions or parts of provisions that are not minimum standards

- Article 6 (purpose of CTA) and Article 7 (Prevention of treaty abuse) are minimum standards

- **Article 7: prevention of treaty abuse**
 - As a minimum standard, jurisdictions should implement either
 - PPT (default rule – minimum standard); or
 - PPT **plus** Simplified LOB

- PPT being minimum standard, it will apply to all its CTAs; India has opted not to grant treaty benefits when PPT is invoked
- India has accepted to apply PPT as an interim measure and intends where possible to adopt LOB provision, in addition or replacement of PPT, through bilateral negotiations

Principal Purpose Test (PPT)

- **Article 7(1), Multilateral Convention (Article 29(9) of OECD MTC 2017)**

- “Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall **not be granted in respect of an item of income or capital** if it is **reasonable to conclude**, having regard to all relevant facts and circumstances, that **obtaining that benefit was one of the principal purposes of any arrangement or transaction** that resulted directly or indirectly in that benefit, **unless** it is established that **granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.**”

- **First limb**

- “... a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is it is reasonable to conclude, having regard to all relevant facts and circumstances, that **obtaining that benefit was one of the principal purposes** of any arrangement or transaction that resulted directly or indirectly in that benefit ...”

- **Second limb**

- “... unless it is established that **granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.**”

- “Benefit” includes tax reduction, exemption, deferral or refund including limitation on taxing rights of source state for dividend, interest, royalties, capital gain, etc.



- The phrase “that resulted directly or indirectly in that benefit” is deliberately broad and include situation where person claims treaty benefit indirectly

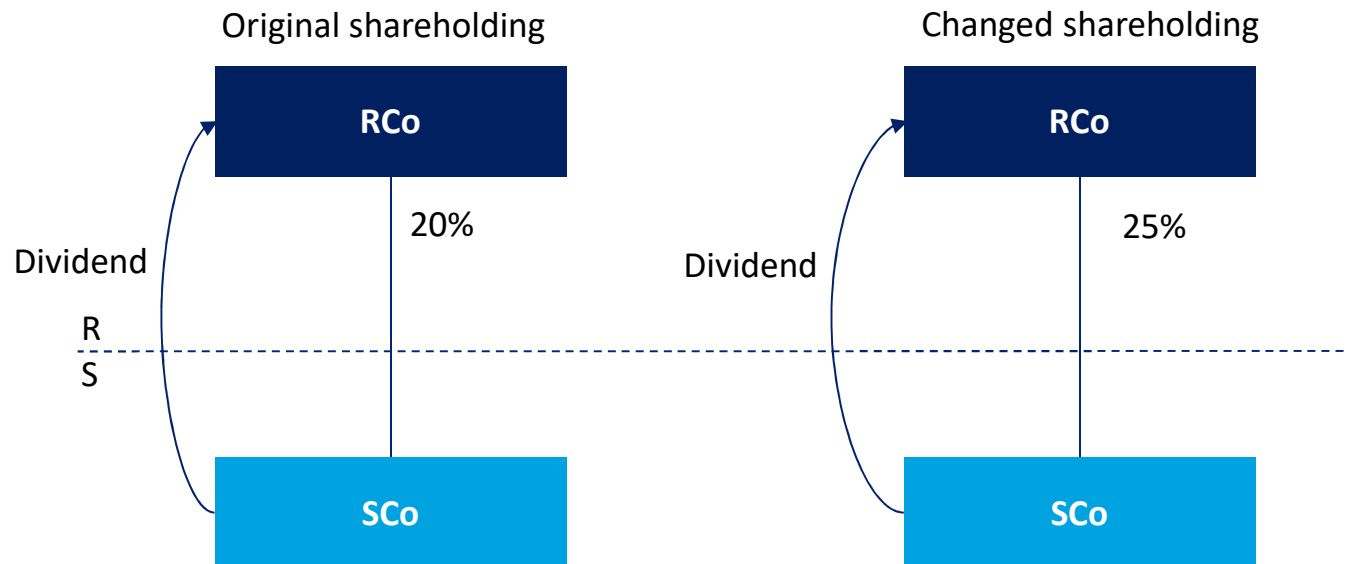


- Terms “arrangement or transaction” to be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions whether or not legally enforceable, for e.g. meetings of board of directors in particular state to claim residency is considered as an “arrangement”

MLI – Article 8

- Article 8 of MLI introduces additional criteria of “**365 days minimum holding period**” for the shareholder to avail concessional tax rates under CTA (**testing period**). Relevant extract of the provision is reproduced below:
 - “... shall apply only if the ownership conditions described in those provisions are **met throughout a 365 day period that includes the day of the payment of the dividends...**”
- India has **opted to apply** such provision (except in case of India-Portugal tax treaty, which already contains similar provision)
- MLI provisions to apply to all its CTA except India - Portugal treaty where there is already a 2 year threshold (unless reservation is made by other CTA partner)

Case study



- Under R-S treaty, for the shareholder to avail concessional tax rate benefit, the shareholder has to hold minimum 25%
- RCo: resident of State R
 - Held 20% of SCo’s shares for last 365 days
- A week before issuing dividend, RCo. increased its shareholding to 25% and it continued to hold such shares for a period of 365 days
- Can this be said to satisfy the minimum holding period under Article 8 of MLI?

India CTAs | MLI to enter into effect from 1 April 2020

List of jurisdictions that have notified tax treaty with India as CTA and have deposited their ratification instruments with OECD Secretariat (WHT and other taxes)

| | | |
|-----------------|-------------|-----------|
| Austria | Australia | Belgium |
| Finland | France | Georgia |
| Ireland | Israel | Japan |
| Lithuania | Luxembourg | Malta |
| Netherlands | New Zealand | Poland |
| Russia | Serbia | Singapore |
| Slovak Republic | Slovenia | Sweden |
| United Kingdom | UAE | |

- **Impact of Article 8 on tax treaties**

- **Opted to apply:** Ireland, Netherlands, Russia, Slovak Republic, France, Israel, Luxembourg, New Zealand, Slovenia, Belgium, Malta, Poland, Canada*
- **Opted not to apply:** Austria, Finland, UK, UAE, Japan, Singapore, Sweden, Norway*, Ukraine*, Iceland*, Georgia
- **Other considerations:** Australia has notified countries but India-Australia Tax Treaty doesn't have beneficial rate for taxing dividend and so India is not notified. Thus Article 8 of MLI shall not be applicable

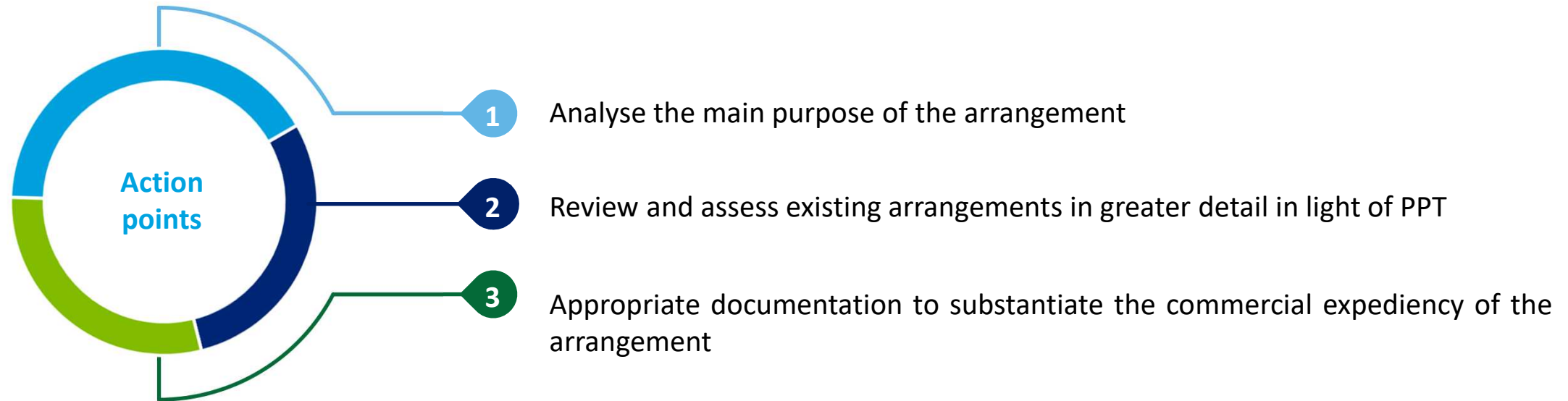
- **MLI will not impact**

- a) India-USA tax treaty (since USA has not signed MLI) and
- b) India's tax treaties with China*, Germany, and Mauritius (since India's tax treaties are not notified by these countries)

*MLI with these countries will enter into effect from 1 April 2021

Key takeaways

GAAR and MLI



Polling question 2

Which of following will have an impact on the distribution of dividend to your overseas shareholder?

- Beneficial ownership
- GAAR
- MLI / PPT / 365 days limitation
- Combination of the above
- Don't know/not applicable

Availability of lower rate under MFN clause

Availability of lower rate under MFN

Background

1 Majority of Indian DTAA's provide a rate of 10% of tax to be withheld on dividends. At the same time, some of the DTAA's signed by India provide for even lower tax rate of 5% on dividends

2 Certain Indian DTAA's carry MFN clause which permits resident of such treaty countries to avail benefit of lower rate, if such lower rate is provided in any other DTAA's signed by India, in specified circumstances

Few OECD countries with MFN clause

Sweden, Finland, Hungary, Netherlands, France

3 One of the main conditions here is that the favourable treaty should be a treaty between India and an OECD member

OECD countries with lower tax rate of 5%

Slovenia, Lithuania, Colombia

- The above countries with lower tax rate became OECD members after signing treaty with India. In such scenario, can MFN clause benefit be availed?

Availability of lower rate under MFN

Sweden, Hungary, Finland Using Slovenia

Slovenia treaty signed on 13 January 2003 and entered into force from 31 May 2005. However, Slovenia became an OECD member only on 21 July 2010

Though Slovenia became an OECD member only on 21 July 2010, company may explore importing the concessional dividend tax rate of 5% under the India-Slovenia tax treaty into these tax treaties w.e.f. the date of Slovenia's OECD membership (i.e., 21 July 2010)

MFN clause in the Sweden/Hungary/Finland tax treaties are **worded widely** – these treaties do not mention a specific time of effecting the change due to MFN clause

Since intent of the MFN clause is to prevent discrimination between similarly placed states and also it is well settled that treaties have to be interpreted in light of their objects and purpose adopting lower rate may be explored



Netherlands/France Using Slovenia/Lithuania/Colombia

MFN clause in the Netherlands/France tax treaties refer to the date of entry into force of the tax treaty with the other OECD country as the date for effecting the change in these tax treaties using the MFN clauses:

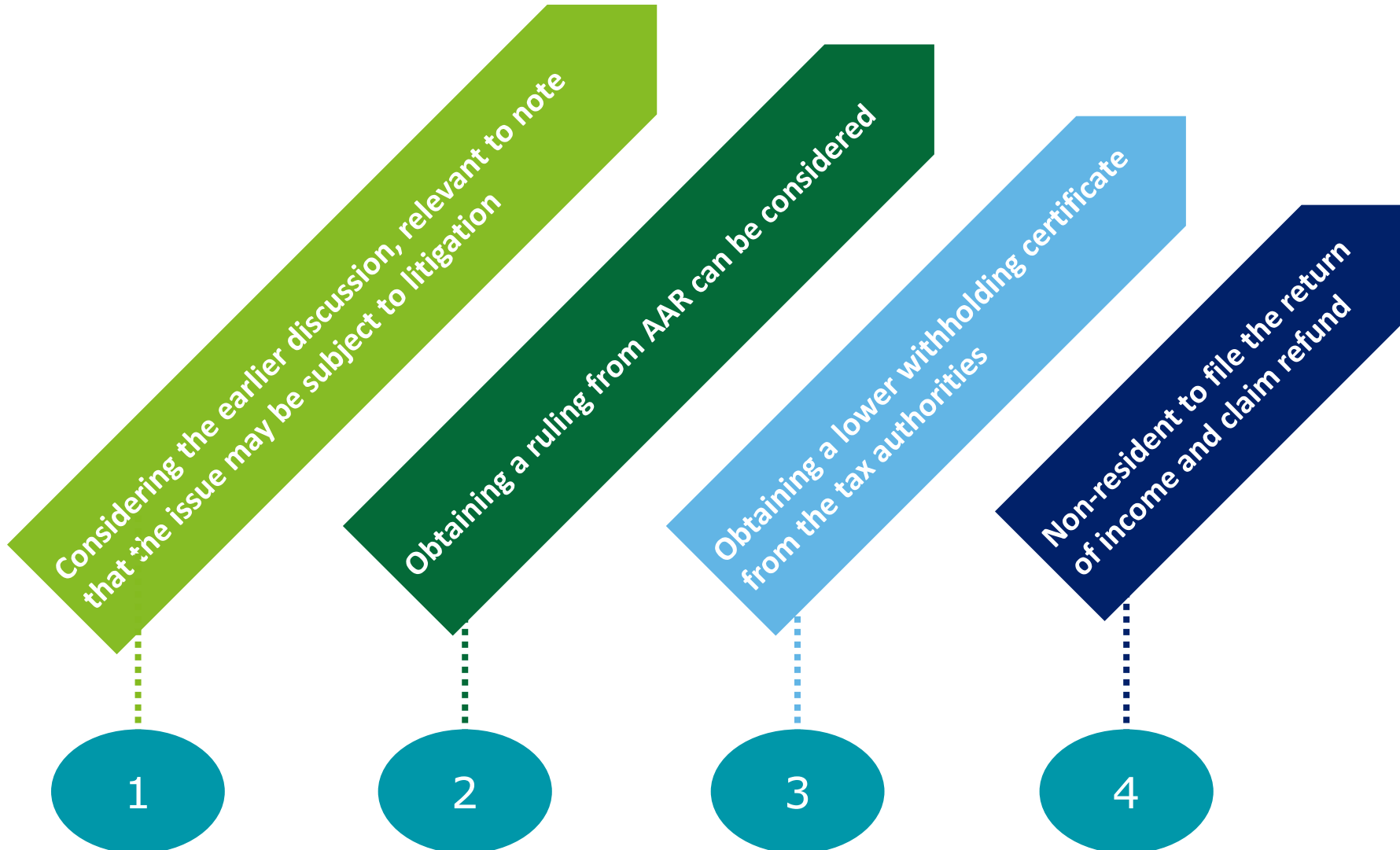
As Slovenia was not OECD member on the date the India-Slovenia tax treaty came into force, the language of the MFN clause in these tax treaties does not enable extending this concession w.e.f. the date of Slovenia's OECD membership (2010)

The result is the same even if benefit of the India-Lithuania or India-Colombia tax treaty is sought, as Lithuania/Colombia became OECD member after the relevant tax treaties entered into force

The result is also the same even if benefit is sought to be taken indirectly through the India-Sweden/India-Hungary tax treaties (after modification in their application on account of Slovenia becoming an OECD member) as this concession was not available when the said treaties entered into force

Availability of lower rate under MFN

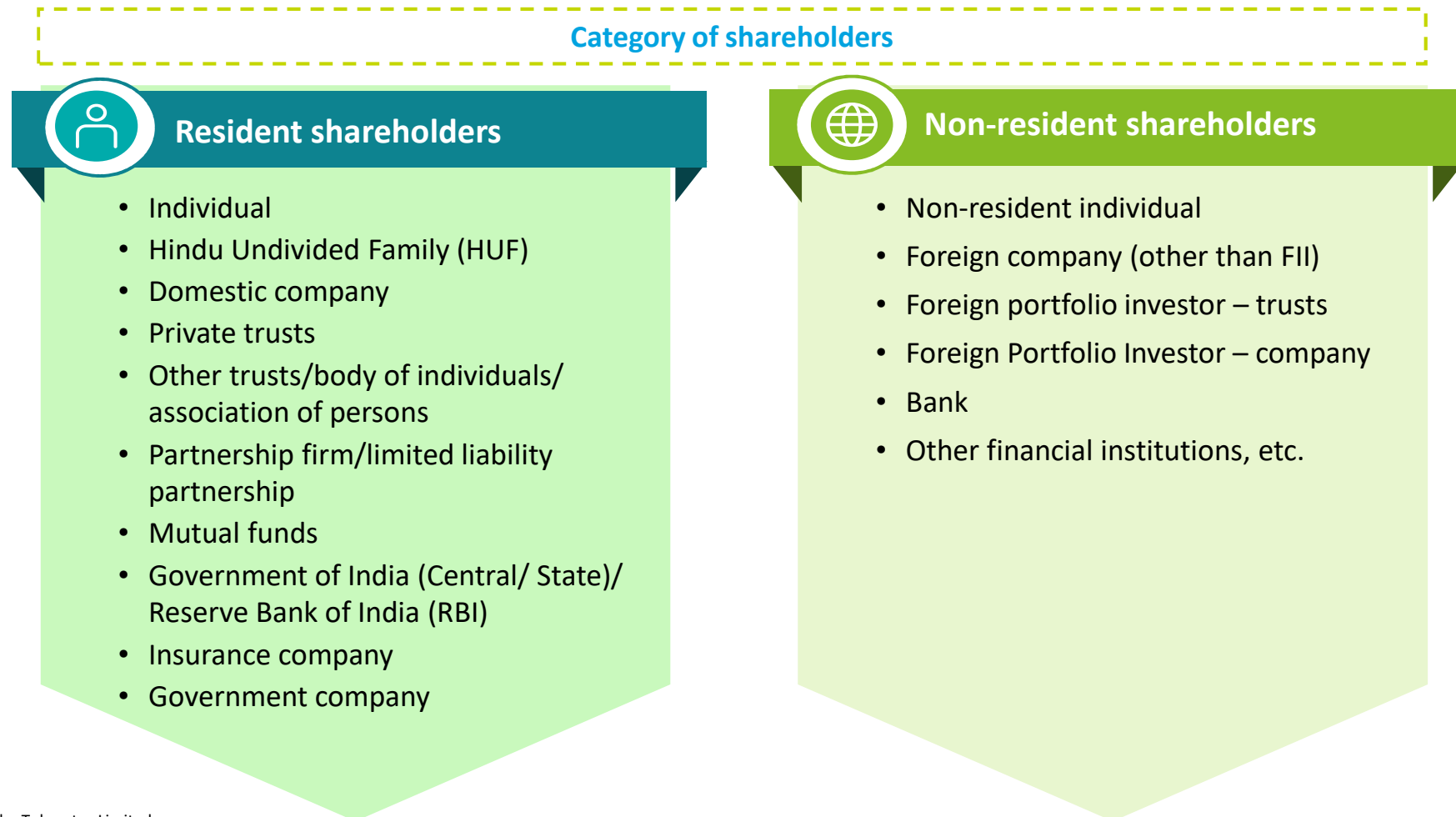
Way forward



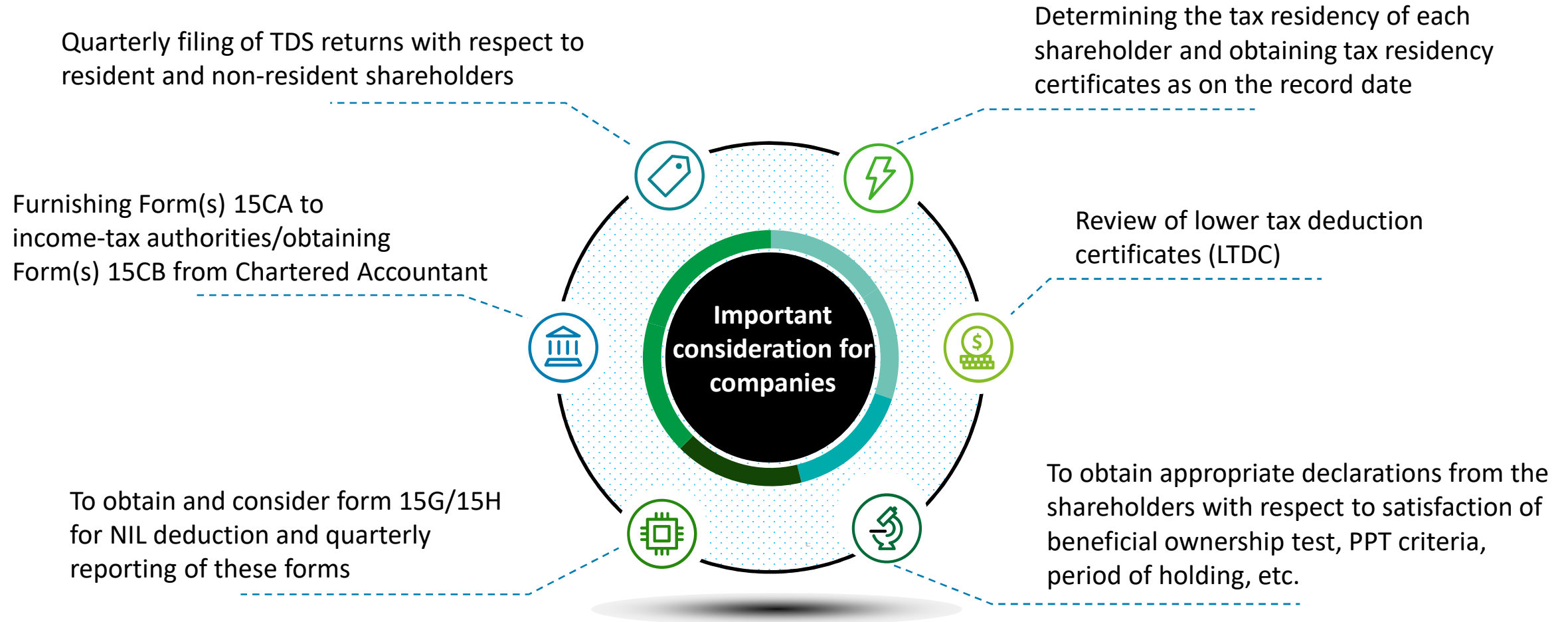
Documentation

Documentation (1/2)

- Many listed companies distribute dividends regularly to their shareholders which includes both resident and non-resident shareholders. It is pertinent to note that WHT rates (including surcharges) for each “category” of shareholders (illustratively specified below) may be different and subject to interpretations, which needs to be considered carefully

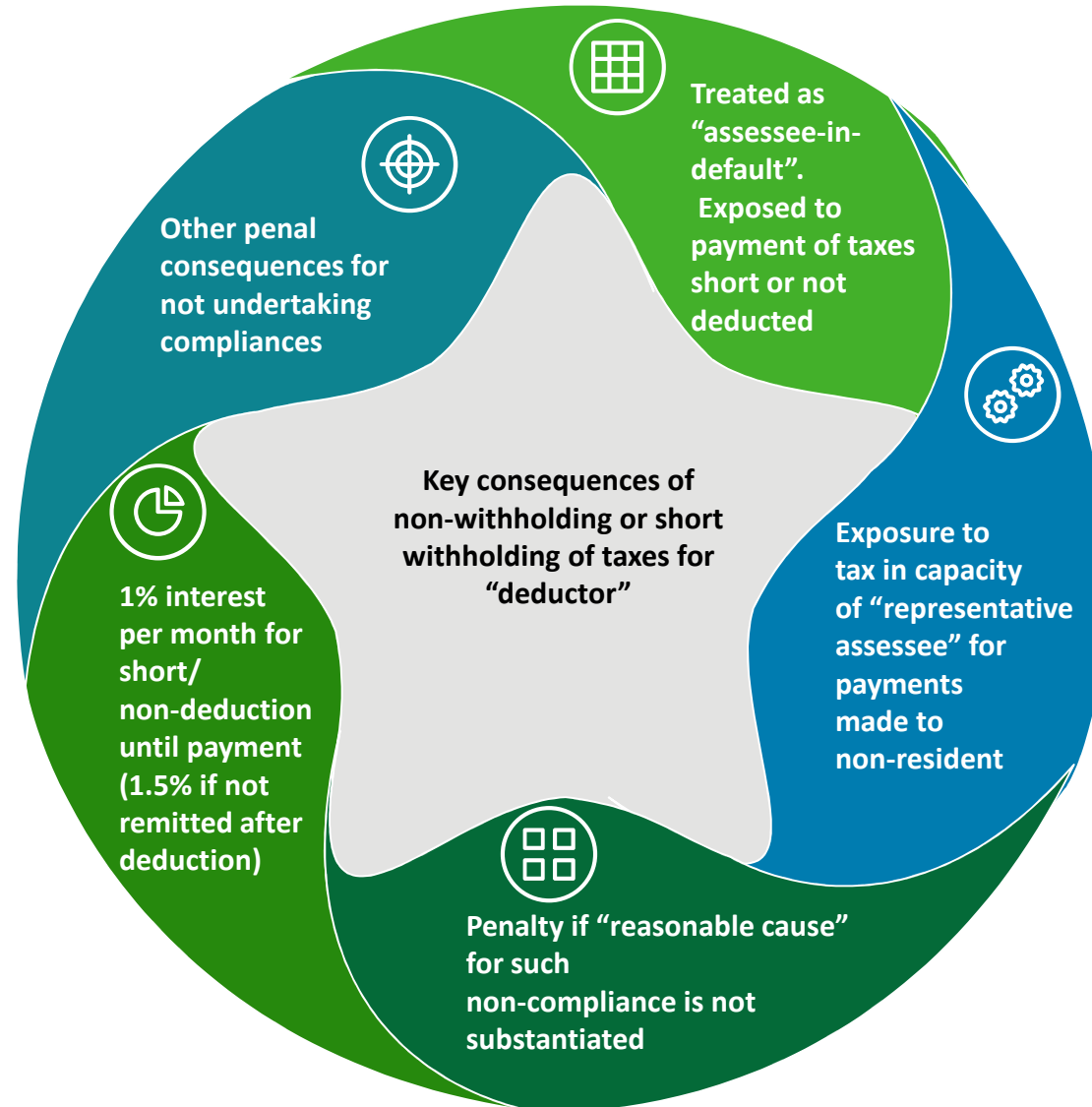


Documentation (2/2)



- Whilst there are several benefits in the classical system of taxing dividends, it brings with it a host of compliances and other factors which a payer domestic company needs to consider

Consequences of non compliance



Question and answers

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