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Global Tax Alert

Indian Court rules on interaction between tax treaty provisions and Indian dividend distribution tax

Executive summary

On 13 October 2020, an Indian Court (Tax Tribunal[1]) held[2] that the dividend distribution tax (DDT) rates, prescribed under the Indian Domestic Tax Laws (DTL), on dividends paid to shareholders by an Indian company is required to be restricted to the rates prescribed under the applicable tax treaty, provided that the conditions for entitlement to treaty benefits are satisfied.

The Tax Tribunal noted that when considering the rates for the taxation of dividend income under the India-Germany tax treaty (the tax treaty applicable to this case), it may not be relevant that the DDT is a liability of the payer company. DDT is levied on the dividend income of the shareholders, despite it being a tax "on the company" and not "on the shareholder." The legislative history of the DDT supports that the DDT is nothing more than a tax on dividend income recovered at a standard rate from the company for administrative convenience and a reduced compliance burden.

This Alert summarizes the Tax Tribunal's decision and considerations for multinational enterprises.

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Detailed discussion

Background

The taxation of dividend income in the Indian DTL has been amended over time. A classical system of the taxation of dividend income previously applied where dividends were taxed in the hands of shareholders and the companies paying the dividends were required to withhold tax on such dividend income. This regime was replaced with the DDT regime in 1997 where the company paying the dividends was liable to pay taxes on the dividends declared/distributed or paid and such dividend income was exempt in the hands of shareholders. The legislative intent of the adoption of the DDT regime was to reduce the administrative burden of the classical system of taxation and provide a single point of taxation. However, the *Finance Act 2020* (FA 2020) abolished the DDT regime, and the classical system of dividend taxation was restored.[3]

In the case before the Tax Tribunal, an issue considered was whether the DDT rate prescribed under the Indian DTL as applicable to dividends paid to German shareholders by an Indian company could be restricted to the rates prescribed under Article 10(2) of the India–Germany tax treaty.

Tribunal Ruling

The Tax Tribunal held that the reduced tax rate on dividend income under the India-Germany tax treaty prevails over the DDT rate under the India DTL. The reasoning behind the ruling is outlined below.

1. The DDT is a tax on dividend income and is collected from the company paying the dividends for administrative convenience:
    - While there is no dispute that the DDT is the liability of payer company pursuant to the Indian DTL, the DDT has its genesis in charging provisions, which covers additional income tax,[4] on the total "income" of every person. Further, "income" is defined to include "dividends" within its ambit under the Indian DTL.
    - The legislative history of the taxation of dividend income supports that the levy of the DDT on the payer company at a standard rate was for administrative convenience and to reduce compliance burdens[5] rather than legal necessity. Additionally, the abolishment of the DDT was considered since the DDT was levied at the same rate on all categories of shareholders, irrespective of the marginal rate at which the recipient shareholder would otherwise be taxed.
    - The reintroduction of the classical system of dividend taxation followed the acknowledgment that while the DDT is levied on the payer company, dividend income should normally be regarded as income in the hands of the shareholders of the company. This position is also supported by the fact that the DDT is economically equivalent to a tax on dividend income, as the amount of profit distributed by the company is reduced by the amount of any DDT liability.
    - It is a settled legal position that if India has entered into a tax treaty to grant tax relief or avoid double taxation, the provisions of the Indian DTL shall only apply to the extent such provisions are more beneficial than the provisions of a tax treaty.
2. DDT is a tax on income and the levy of tax on any income beneficially derived by a German resident is subject to the India-Germany tax treaty:
    - The Tax Tribunal stated that when considering the rates for the taxation of dividend income under the tax treaty, it is not relevant that the DDT is a liability of the payer company.
    - The India-Germany tax treaty was notified in 1996 prior to the introduction of DDT provisions in 1997. The India-Germany tax treaty restricts the rate of tax on dividend income to 10% of the gross dividend amount.

The Tax Tribunal also placed reliance on the Delhi High Court (HC) ruling in *New Skies Satellite*,[6] where the HC did not permit the application of retroactive amendments made under the Indian DTL to tax treaty provisions. The HC held that the tax treaties represent a reciprocal bargain between the two countries and need to be interpreted in good faith. While the Parliament can legislate domestic laws, it cannot unilaterally amend the tax treaty which operates on the principle of reciprocity.

While the current ruling is in favor of the taxpayer, the Tax Tribunal restored the matter to the Tax Authority for the limited purpose of verifying whether the beneficial owner of the dividend income has a permanent establishment (PE) in India, and if so, whether such income is effectively connected with the PE, in which case the reduced rate under the India-Germany tax treaty would not be applicable.

Implications

The issue of whether the DDT is subject to tax treaty provisions is highly contentious as the levy is imposed on and recovered from the payer company. This case is the first ruling on the subject and the Tax Tribunal held that the DDT is effectively a tax on dividend income and is subject to tax treaty provisions.

The Tribunal also considered the decision made in *New Skies Satellite* that ruled reciprocal bargains as entered between the countries cannot be amended unilaterally and as such, the amendment of domestic law cannot be read into the tax treaty provisions without amending the tax treaty itself. While the Tax Tribunal was concerned with the India-Germany tax treaty notified in 1996, the conclusion of the Tax Tribunal in this case may also apply to other tax treaties, including any tax treaties notified after the introduction of the DDT.

The Tax Tribunal ruling is of utmost relevance to multinational enterprises with Indian affiliate companies that have discharged DDT liabilities on past dividend distributions.[7] Businesses should review the possibility of seeking refunds of excess DDT paid over the tax treaty dividend withholding rates.

Endnotes

1. Income-Tax Appellate Tribunal.
2. *Giesecke & Devrient (India) Pvt. Ltd.* [TS-522-Tribunal-2020].
3. See EY Global Tax Alert, *India releases the 2020-21 Union Budget*, dated 4 February 2020.
4. Tax is defined under the Indian DTL to include DDT, being additional income tax.
5. Compliance in terms of withholding taxes, tax collection from individual shareholders and grant of refund, wherever applicable etc.
6. *New Skies Satellites* [382 ITR 114].
7. Applicable for distributions made prior to 1 April 2020 as the Indian DTL has been amended and DDT abolished on dividends declared and paid after 1 April 2020.

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