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India Tax Alert

News from International Corporate Tax Advisory

Foreign investors need to consider impact of India's new dividend withholding tax

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

Executive summary

On 1 February 2020, the Honorable Finance Minister tabled the Finance Bill, 2020 (FB 2020) in Parliament as part of the Union Budget for the Financial Year (FY) 2020-21. On 27 March 2020, the FB 2020, after approval by Parliament, received Presidential assent and is enacted with effect from 1 April 2020. The Finance Act, 2020 (FA 2020) introduces a significant change to the current system of dividend taxation under the Indian Income Tax Law (ITL) by abolishing the dividend distribution tax (DDT) which was levied on a domestic company distributing dividends. Instead, the ITL will now revert to the classical system of taxing dividends in the hands of the shareholder.

The classical system of taxing dividend will require the payer domestic company to withhold tax on the gross amounts of dividends paid to a shareholder. The ITL provides for withholding tax (WHT) at the rate of 20% on the gross dividends, in the case of non-resident shareholders. Reduced WHT rates may apply if a non-resident shareholder is eligible for benefits under an applicable tax treaty. Number of India's tax treaties provide for dividend WHT rates of 10%/ 15%. Some tax treaties may even provide for a 5% dividend WHT, either directly or indirectly, by application of the "most favored nation (MFN)" clause in the tax treaties. However, benefits of lower dividend WHT under the tax treaty is subject to satisfactory fulfillment of tax treaty eligibility criteria. These conditions primarily include qualifying as a resident as per the tax treaty provisions, meeting the criteria set out for anti-abuse tests such as beneficial ownership, Principal Purpose Test (PPT) and/ or Limitation on Benefits (LOB), as may be applicable as well as specific conditions that may exist in certain tax treaties for the lower WHT (e.g. minimum shareholding requirement, minimum holding period etc.).

Building a better working world

Hence, a careful review of tax treaties, including the wording of the MFN clause, along with synthesized texts incorporating the multilateral instrument (MLI) modifications, would be necessary to determine treaty eligibility and appropriate WHT rate.

Foreign investors would need to evaluate the impact of the change in dividend taxation system on their Indian legal entity and holding structures and give a careful consideration to its implications on taxation of cross-border dividend flows from Indian operations.

Detailed discussion

Background

India's dividend taxation policy has witnessed many changes over the years, guided by varied objectives. The FA 2020 has re-introduced the classical system for taxing dividends as was prevalent from 1961 to 1997 and for a brief period from 2002 to 2003. India introduced the DDT regime in 1997. The stated objective of the DDT regime was to encourage companies to retain the bulk of their profits and plough them into fresh investments for future growth. However, the above system of taxing dividends was considered inequitable as dividend is income in the hands of the shareholders and not in the hands of the company. Therefore, in the year 2002, the incidence of tax on dividends was shifted on to the shareholders, at the rate applicable to them. In 2003, taxation of dividend again shifted to the corporate level, keeping in view the perspective of ease of collection at a single point.

While the DDT regime resulted in ease of tax collection, it was considered as regressive and as having a distortive effect in cross-border situations. Specifically, where the residence jurisdiction of the shareholder taxed foreign dividend but granted foreign tax credit, a foreign investor faced challenges in availing the DDT as a credit since DDT incidence was not in the hands of shareholders. Thus, the DDT significantly increased the cost of Indian investment/ operations. The DDT regime was a cause of concern for investors despite the reduction in the corporate tax rate to 22% by the Taxation Laws (Amendment) Act, 2019 with effect from FY 2019-20.

The FA 2020 has reintroduced the classical system of taxing dividends in the hands of the shareholders. Accordingly, the amendment will now shift the incidence of tax from the company to the hands of the shareholders. The amendment will be effective from FY 2020-21 and will apply to dividends distributed on or after 1 April 2020.

Taxing dividends under the classical system

The classical system of taxing dividends will result in taxation of dividends in the hands of the shareholder. The payer company is under an obligation to withhold tax on the gross amounts of dividends at the time of payment or credit. The FA 2020 provides for withholding at the rate of 20% on the gross dividends, in the case of non-resident shareholders. It may however be noted that India has a wide network of bilateral tax treaties which could provide for a reduced rate. Number of India's tax treaties, especially with key trade and investment partners such as Australia, France, Germany, Japan, the Netherlands, Sweden, Switzerland, UK, USA etc., provide for 10%/ 15% WHT on dividends. Additionally, there are a few tax treaties such as those with Hong Kong, Malaysia, Mauritius etc. which provide for 5% WHT on dividends. It may also be noted that some of India's tax treaties have an MFN clause, which can be evaluated to see whether the dividend WHT rate originally negotiated and prescribed in the tax treaty can be further reduced. Some of the tax treaties prescribe additional conditions such as the requirement for minimum shareholding or a minimum period of holding to qualify for the lower dividend WHT. Hence, a careful review of India's tax treaties, wording of the MFN clauses, along with the synthesized texts containing the MLI modifications, would be necessary to determine treaty eligibility and the appropriate dividend WHT rate.

Key issues/ considerations for availing lower WHT under the tax treaty

The classical system of taxing dividends as reintroduced by the FA 2020 will shift the incidence of taxation from companies to the shareholders. This can provide for an effective mechanism for improved cross-border dividend flows and utilization of cash from Indian operations. However, the following aspects require careful consideration, specifically for the purpose for determining the eligibility to claim tax treaty benefits:

- **Qualification as person and resident as per tax treaty provisions** – The tax treaty benefit can be claimed only by a taxpayer who is a "person" and "resident" as defined in the relevant tax treaty. Whether a fiscally transparent entity (e.g. certain forms of limited liability companies and partnerships) are to be considered as residents under a tax treaty has been a contentious issue in the Indian context and would need to be specifically examined where the shareholder of an Indian company is organized as a fiscally transparent entity.
- **Impact of MLI on India's tax treaties** – India was one of the first signatories to the MLI on 7 June 2017. India also completed the ratification process and deposited the instrument of ratification, along with its

final positions on MLI provisions, with the OECD on 25 June 2019. The MLI entered into force for India on 1 October 2019 and will be effective for 20 of India's tax treaties from 1 April 2020. These include treaties with some of the key trade and investment jurisdictions such as Australia, France, Ireland, Netherlands, Japan, Singapore, Sweden and the UK. However, some of India's tax treaties, such as those with the US, Mauritius and Germany currently remain outside the realm of MLI. Pursuant to the MLI, BEPS Action 6 minimum standard is expected to be included in India's tax treaties, which will result in the following:

- A new preamble stating the purpose of tax treaties i.e. elimination of double taxation without creating opportunities for non-taxation or reduced taxation
- An anti-abuse treaty provision which can be the PPT, the PPT and a simplified LOB provision or a detailed LOB and anti-conduit rules. The PPT seeks to deny benefit under the tax treaty in every case where it is reasonably possible to conclude that in the facts of the case, one of the principal purposes of an arrangement or a transaction, is to obtain a tax benefit, directly or indirectly.

- Beneficial ownership of dividend income – A direct recipient of dividends may not qualify as a "beneficial owner" if from the very inception of his status, the recipient's right to use and enjoy the dividend is constrained by a contractual and legal obligation to pass on the payment received to another person. The condition of beneficial ownership is generally inserted in the tax treaty provisions, due to which the benefit of reduced tax treaty rates is available only in cases where the recipient of dividend is a beneficial owner. Where some of tax treaties do not provide for a specific condition of satisfaction of beneficial ownership for dividend, yet the concept of beneficial ownership is inbuilt and embedded such that the same need to be adhered to satisfy the condition for claiming tax treaty benefits.
- General Anti-avoidance Rule (GAAR) –GAAR was introduced in the ITL with effect from 1 April 2017 and gives wide powers to the tax authorities to deny tax benefits arising from an "impermissible avoidance arrangement", including benefits from a tax treaty, if the main purpose of the arrangement is to obtain the tax benefit and certain other conditions are satisfied.

The above would be some of the key considerations that need to be evaluated while determining availability of reduced WHT rate under a relevant tax treaty for dividends paid by an Indian company to its non-resident shareholder/holding company. Typically, a holding company which has sufficient local substance to manage its assets, operations and associated risks, could be eligible for tax treaty benefits. Such a company could be in a position to (i) reasonably explain the benefit that arises other than under the tax treaty (ii) make sure that the object is inextricably linked to core commercial activities and (iii) establish that the benefit obtained from the tax treaty is consistent with its object and purpose.

Roll over benefit in case of dividend flows

In order to remove the cascading effect of taxation on dividend distributed by a subsidiary company to its domestic holding company, the FA 2020 provides for a roll over benefit by way of deduction of dividend distributed by a subsidiary being a domestic company or foreign company or business trust regardless of percentage of shareholding. Accordingly, a domestic holding company can claim dividend received from its subsidiary (being domestic or foreign) as a deduction, to the extent dividend is distributed by such holding company.

Interplay with secondary adjustment provisions under transfer pricing (TP) regulations

The Finance Act, 2017 introduced the concept of "secondary adjustment" in the Indian TP legislation with an intention to protect the tax base in India and to equalize the cash balance and the actual profit earned by the taxpayer. Under the Indian TP regulations, the taxpayer who is subject to primary adjustment under the prescribed scenarios, is required to bring in the amount of primary adjustment into India within the specified period. If not repatriated on time, the primary adjustment will be deemed to be a loan advanced to associated enterprise (AE) and on which interest will be imputed at the prescribed rate. Further, the Finance (No. 2) Act, 2019 provides the taxpayers with an option to make one-time tax payment at the rate of 20.97% (cash tax) in case the primary adjustment is not brought into India within the prescribed time limit. It is generally understood that one of the reasons for the cash tax option was to account for a potential loss of DDT, assuming the money was brought into India and thereafter distributed as dividends. With the change in the dividend taxation system, taxpayers who are subject to a secondary adjustment would need to evaluate their options for equalizing the cash payment with the primary TP adjustment.

Implications

The FA 2020 abolishing the DDT regime and replacing it with a classical system marks a fundamental change in dividend taxation in India. The DDT regime had made benefits of an applicable tax treaty largely irrelevant for a non-resident shareholder since the DDT was a tax levied on a domestic company and it was generally regarded that a tax treaty cannot be relied upon for reducing the rate of DDT. However, with the shift in dividend taxation to the hands of the shareholder, non-resident shareholders would need to consider whether they can rely on India's tax treaties to seek a reduced WHT rate on the dividends. Of specific relevance would be evaluation of anti-abuse provisions such as PPT, beneficial ownership and GAAR to qualify for tax treaty benefits. The tax authorities can also be expected to scrutinize any claim for reduced WHT rate under tax treaties more closely, including any position seeking to reduce rates by relying on the MFN clause. Taxpayers would need to be well prepared to demonstrate their treaty entitlement claim. The payor domestic company would also need to be in a position to make this assessment for determining the appropriate WHT rate while distributing dividends to its non-resident shareholder. Absence of proper diligence at the time of withholding tax could result in onerous consequences on the payor in case of a WHT default.

Foreign investors would need to evaluate the impact of the change in dividend taxation system on their Indian legal entity and holding structures and give a careful consideration to implications on taxation of cross-border dividend flows from Indian operations.

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