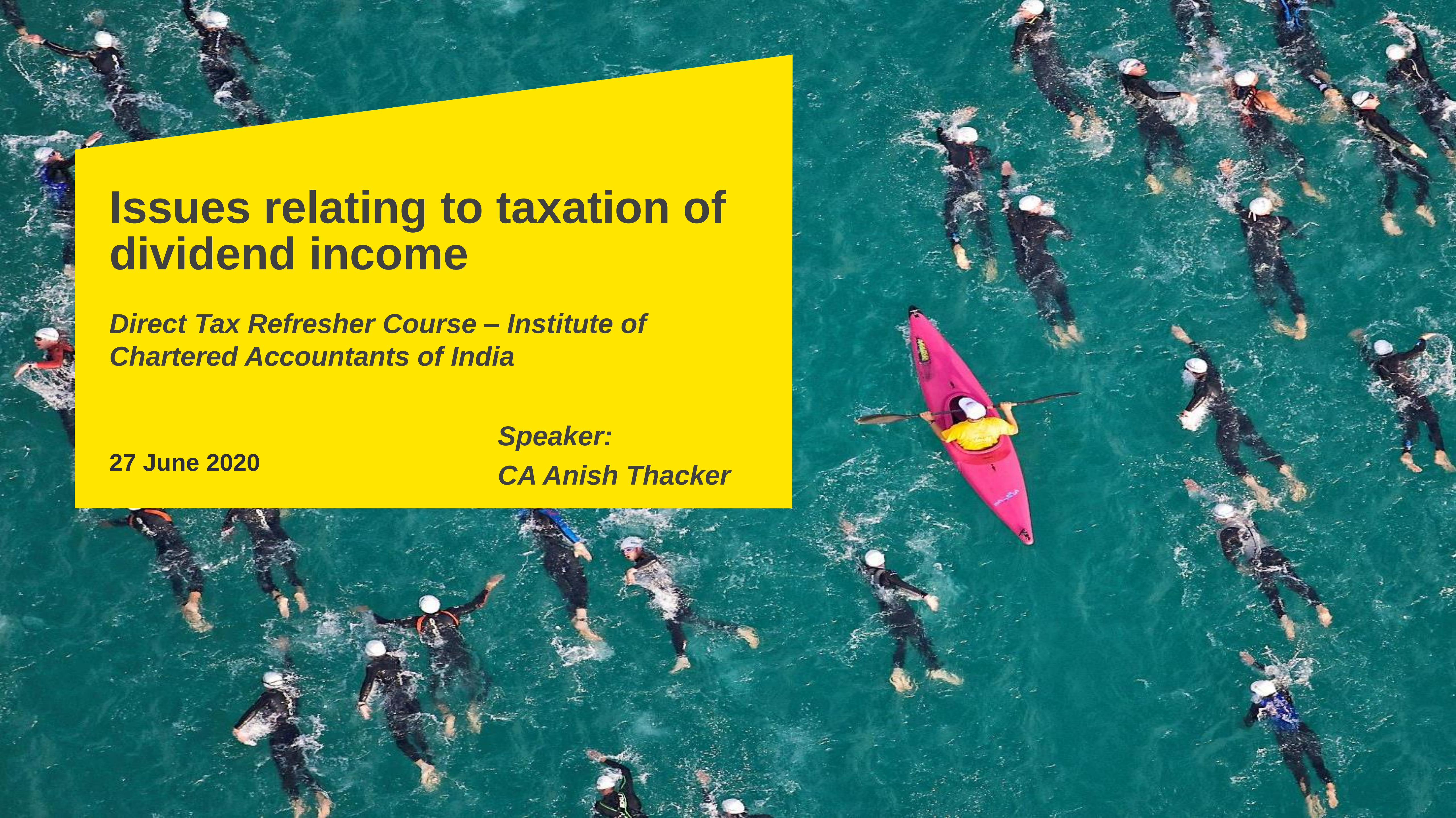

Issues relating to taxation of dividend income

Direct Tax Refresher Course – Institute of Chartered Accountants of India

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Contents

General Overview - Taxation of dividend income

- Prior to 1 April 2020, dividends distributed by an Indian company were exempt in the hands of the shareholders – The same were subject to Dividend Distribution Tax [DDT] in the hands of the payer company at the rate of 20.56%

- For FY 2020-21 onwards - Dividend income is taxable in the hands of the shareholders*. Further, for removal of cascading effect, deduction is allowed in respect of certain intercorporate dividends

- Income-tax rates on the dividend income for each class of Resident tax-payers is as below

Resident shareholder	Tax Rate
Individual/ HUF	Depending on the slab rate - Maximum Marginal tax of 35.88% (Surcharge on dividend is capped at 15%) [Base tax of 30%+ Surcharge of 15%+ Education cess of 4%]
Trust	35.88% (same as above)
LLP/ Partnership firm	Maximum Marginal tax of 34.94% (Surcharge applicable at the rate of 12%) [Base tax of 30%+ Surcharge of 12%+ Education cess of 4%]
Indian company from any other Indian Company	Maximum Marginal tax of 34.94% [Base tax of 30%+ Surcharge of 12%+ Education cess of 4%] - Deduction under section 80M of the Act is also available for companies which have opted for lower corporate tax rate under section 115BAA/ 115BAB of the Act

**Subject to the beneficial rate under the relevant tax treaties, in case of a non-resident shareholder*

Withholding tax on dividends

Withholding tax rates

Shareholder	Withholding as per the Income-tax Act, 1961 (Act)	Withholding tax rate as per tax treaty
Resident shareholder	10%* (Section 194 of the Act)	N.A.
FPIs	20% (++applicable surcharge and cess)	N.A. - Currently the Act does not take cognizance of tax treaty rates for withholding purposes (Refer discussion in the ensuing slide)
Non-resident shareholders - Non FPIs	20% (++applicable surcharge and cess)	Reduced rate i.e. 5%, 10%, 15%, 20% as applicable may be considered (subject to availability of tax treaty benefits)

Points for consideration

- Surcharge rate to be applied at the time of tax withholding to a non-resident (specifically in case of non-corporate FPIs)
- In cases where tax treaty benefits are available, excess taxes deducted can be claimed as refund in tax return or utilised towards payment of any other tax liability during the relevant tax year
- Documentation requirements for tax treaty claim at the time of withholding

** In case where the amount of dividend paid/ likely to be paid to a shareholder exceeds INR 5,000 during a financial year. Further, pertinent to note that Press Release issued by Central Board of Direct Taxes (CBDT) dated 13 May 2020, provides for the lower withholding rate of **7.5%** from 14 May 2020 to 31 March 2021.*

Withholding tax on dividends – Hon'ble SC decision in case of Pilcom

- The Hon'ble SC in a recent ruling in case of PILCOM v CIT [2020] 116 Taxmann.com 394 (SC), in the context of section 194E of the Act (withholding on payments to a non resident sports person, which is similar to section 196D of the Act) dealt with respect to applicability of the tax treaty provisions at the time of tax withholding, the Hon'ble SC held that the obligation of a person to withhold tax at source under the provisions of the domestic law i.e. the Act, is not affected by the provisions of a DTAA.

- Further, the Hon'ble SC stated that mere fact that the taxpayer is entitled to benefits under a DTAA, by itself, cannot absolve the withholding tax obligation of the payer under the domestic law. Where, the taxpayer is entitled to the benefits of a DTAA, the same is to be claimed by the taxpayer (in the return of income so filed by it) and where it is correctly claimed, the taxpayer would be refunded the excess tax so withheld along with the interest, if any.

- In light of the above judgement, with respect to withholding tax on dividend income, the following merits consideration

Relevant sections	Tax Rate
194LBA(2)	Payment of Interest and Dividend income by Business Trust – Withholding to be at a flat rate of 10% (without recourse of any treaty benefits)
196D	Income of FPIs from Securities – Withholding to be at a flat rate of 20% (without recourse of any treaty benefits)

Taxation of dividends - Select tax treaties

- Income recipient must be a ‘beneficial owner’ of the dividend income – the term not defined in the Act and tax treaties
- Guidance may be taken from the OECD commentary, **when recipient's right to use and enjoy the income is constrained by a contractual or legal obligation to pass on the payment received to another person;**

Country Name	Tax Rate as per Tax treaty
Singapore	10%*/ 15%
Mauritius	5%#/ 15%
Hong Kong	5%$
USA	15%@/ 25%
Netherlands	10%$

** if the recipient beneficial owner of the dividend income is a company that owns at least 25% of the shares of the company paying the dividend.*

 # if the beneficial owner of the dividend income is a company that owns at least 10% of the shares of the company paying the dividend.

$ if the recipient is the beneficial owner of the dividend income is a company.

@ if the recipient being beneficial owner of the dividend income is a company that owns at least 10% of the voting stock of the company paying the dividend.

Beneficial ownership

- Shareholder receiving dividend should own and hold the dividend for his own benefit and not as an agent, trustee, or nominee for some other person;
- Shareholder should have the entire rights to decide upon usage of the dividend so received;
- Shareholder should not be obligated to pass on such income to a third party by way of agreement or otherwise;
- Shareholder should have the right and independence to make decisions in relation to the investment and not be dependent upon or acting upon the directions of the controlling shareholder
- Shareholder should bear economic risk associated with the investment;
- Shareholder should not act as a mere fiduciary or an administrator acting on account of the controlling shareholder.

Taxation of dividends - Select tax treaties

Most Favoured Nation Clause (MFN Clause)

- In a tax treaty, MFN clause is incorporated where one contracting country grants MFN status to the other contracting jurisdiction, in relation to specified income stream.
- In such circumstances, residents of MFN country are accorded the same **beneficial treatment** it has extended or it may extend (in a future) to a resident of any third jurisdiction
- MFN Clauses with the 6 specified countries provides that if rate/ scope of article is restricted with any other treaty with a OECD member which India has, effective after a specified date, then the favourable treatment shall be granted.
- India-Slovenia and India-Lithuania tax treaties also provides that dividend income is taxable at the rate 5%, where the shareholder (being a beneficial owner) owns at least 10% of the capital of the company paying dividends.
  - *Slovenia and Lithaunia were not OECD members when the respective treaties were entered and became OECD members on a later date*

Recent developments

- Recently, Columbia has become an OECD member on 28 April 2020. As per India-Columbia tax treaty, dividend is taxable at the rate 5%, not subject to condition of any minimum shareholding in the company declaring dividend.

Countries having MFN clause in treaty with India

- Switzerland
- Finland
- France
- Sweden
- Netherlands
- Hungary

Beneficial Treatment

- Lower tax rate for source country taxation; or
- Limited scope of definition of a particular income stream.

Whether favourable benefits of India-Slovenia/ Lithuania/ Columbia tax treaty be availed, even when such countries were not OECD member countries at the time of signing the tax treaty?

Aspects relevant for claiming tax treaty benefits - Dividend income

Considerations for tax treaty eligibility

01 Qualify to be a ‘person’ and ‘resident’

02 TRC, Form No 10F, Declarations/ undertakings

03 Beneficial ownership

04 Limitation of Benefits

05 GAAR and MLI

Section 80M of the Act - Overview

- Rollover benefits available only for **domestic companies,** whose gross total income includes dividend from another domestic company, foreign company or business trust.

- The amount of **dividend received** shall be allowed as deduction, if such amount is **distributed** as dividend on a before the due date.
  - Due date means the date **one month prior** to the date for furnishing the return of income under section 139(1) of the Act
  - No condition of maintaining or fulfilling the sequence of receipt on onward distribution
  - The Act requires amount to be distributed to the shareholders, before the due date, mere declaration on a before the due date may not make company eligible to claim 80M deduction. Reliance could be placed on the Hon'ble Supreme Court's decision in the case of ***Punjab Distilling Industries Limited (57 ITR 1)***, wherein the term 'distribution' is explained as Actual/ constructive payment by way of journal entries, in which liability is acknowledged towards shareholders.

- Eligibility of deduction under section 80M of the Act may be seen vis-à-vis dividend income accrual under section 8 such that it forms part of Gross Total Income. ***Actual receipt*** may not be necessary.
  - Dividend income shall be deemed to be the income of the financial year in which it is declared/ distributed/ paid;
  - Interim dividend shall be deemed to be the income of the financial year in which the amount of such dividend is unconditionally made available by the company to the member.

Section 80M of the Act – Select Issues

Issue 1 –Deduction under setion 80M of the Act on Net Dividend income/ Gross Dividend income

Particulars	**Scenario 1 – Only dividend income**	**Scenario 2 – Dividend income + Other income**
Business Income	-	200
Dividend income	100	100
(less) Interest expense	(20)	(20)
Gross Total income (GTI)	80	280
Dividend up streamed	100	100
Less: 80M deduction	**80***	**80 or 100?****

*Section 80A(2) of the Act states that deduction under chapter VIA of the Act, may not exceed GTI of the taxpayer

** Alternate views possible. Deduction under section 80M of the Act may be restricted to **INR 80** only as section 80M of the Act says that GTI of any domestic company in any previous year ***includes any income by way of dividend***.

- This would imply that income which is included in GTI is net dividend, after considering claim of expenditure under the head of Income from other sources

It can also be argued that the intention of legislature to provide deduction to specific nature of income has always been to restrict the deduction to such net taxable income included in GTI. Analogy can be drawn from the provision of section 80T (capital gains), 80RRA (Remuneration by Indian Citizen), 80QQA, etc all such section provides deduction from the specific nature of income included in GTI.

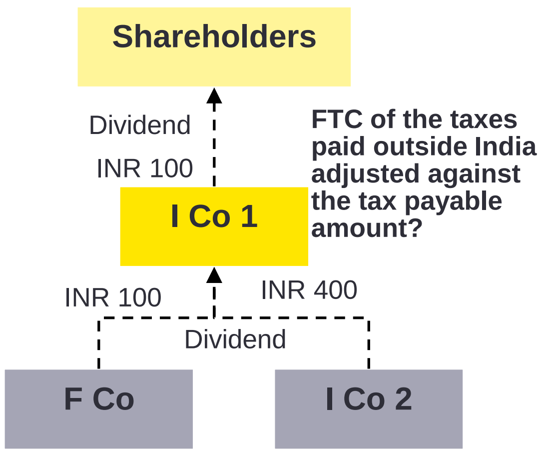
Section 80M of the Act – Select Issues

<u>Issue 2 – Interplay of dividend income from a foreign company taxable at the concessional tax rate under section 115BBD, deduction under section 80M of the Act and Foreign tax credit</u>

- Per section 80M of the Act, that the deduction will be available to the extent, the dividend amount received which is <u>included in gross total income</u>. Section does not distinguish/ prioritize distribution of dividend from Foreign Company/ Indian Company
  - It may be possible to take Beneficial allocation by the I Co 1 which has dividend income from specified foreign company (which is taxable at concessional rate of 15%) and another Indian company.
  - Amount distributed can first be set off against, the Indian dividend income and the balance can be subjected to tax as per the beneficial provisions of section 115BBD of the Act.

- I CO 1 may not claim FTC of taxes paid outside India, when the entire dividend income included in GTI is claimed as deduction under section 80M of the Act. Such income may not be considered as a doubly taxed income.

- In case where the entire amount of dividend income is not upstreamed/ onward paid, then FTC can be claimed against the balance taxable income.



F CO *is a* ***specified foreign company*** *(in which I Co's shareholding is more or equal to 26%), Dividend income of I Co 1 from F Co will be taxable as per the beneficial provisions of section 115BBD of the Act.*

Section 80M of the Act – Select Issues

Issue 3 – Dividend income taxable as IFOS and allowance of interest expense

- Since section 56 of the Act, specifically covers section 56, within its ambit, dividend income will be taxable under the head Income from other sources (IFOS), irrespective of the fact whether the investment in shares in classified under stock in trade or treated as capital asset.

- Per section 57 of the Act, deduction shall not be allowed of any expense (other than interest expense), exceeding 20% of dividend income
  - Arguably, interest expense will not be allowable as deduction in the absence of dividend income.

- Though the dividend income is taxable as IFOS, where investment is made in an Investee company to acquire the controlling interest, the **deductibility of the interest expenditure** may be looked into citing specific facts of the case.

- It may be noted that if dividend taxation takes place under the scheme of MAT, then the expense deduction would be governed by the provisions of section 115JB and any restrictions under the head PGBP/ section 57 (including proviso) may not apply.

Questions

Glossary

Abbreviation	Term
Act	Income-tax Act, 1961
DTAA	Double Tax Avoidance Agreement
FPIs	Foreign Portfolio Investors
FTC	Foreign Tax credit
GAAR	General Anti-Avoidance Rules
GTI	Gross Total Income
HUF	Hindu Undivided Family
IFOS	Income from Other Sources
LLP	Limited Liability Partnership
MAT	Minimum Alternate Tax
MFN	Most Favoured Nation
MLI	Multilateral Instrument
OECD	The Organisation for Economic Co-operation and Development
PGBP	Profits and Gains of Business or Profession
SC	Supreme Court of India
TRC	Tax Residency Certificate

Thank You

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