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India's Dividend Distribution Tax: An Anomaly Outside Tax Treaties!

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In international customary law, the scope of bilateral tax conventions is not exhaustive and instead limited by the temporal scope set out in 'taxes covered' clause. It is true that the scope of such clause, albeit with additional procedural stipulations, is ambulatory and taxes subsequently enacted under the domestic law provisions by treaty partners are also covered. However, such coverage is contingent upon changes to the domestic law being 'identical or substantially similar'. Consequently, disputes arise when new forms of taxes, though intending to replace those covered under the treaties, are designed materially differently thereby leading to denial of treaty benefit. The levy of 'taxes on distributed profits' (colloquially referred as 'dividend distribution tax' or 'DDT') of India, levied until recently, is a case to the point. Though the DDT levy has been contentious with regard to availability of Foreign tax credit, it was not tested, as such under the domestic law of any of India's treaty partners. A recent India tax tribunal order has concluded that DDT is covered within the tax treaty framework and in this context, this post contextualizes the salient-features of tax treaty design which affect taxpayers' entitlement.

Background: Unraveling the DDT design

Traditionally countries tax companies on their profits and the dividends distributed which, unless exempted by source states, are taxed in the hands of shareholders in the country of residence. The Indian Income Tax law[1] traditionally adopted such scheme[2] until 1997 when DDT scheme was introduced. With the change, dividend income was exempt in the hands of the shareholder (irrespective of the residential status) and instead, a levy by way of 'additional tax' was imposed on India companies distributing the dividend. This change was ostensibly premised on the convenience principle, considering it is expedient to collect the tax from one person (i.e. dividend distribution company) instead of multitudes of shareholders. Besides, resident shareholders were taxed at varying rates on the level of total income and the DDT law brought about a uniform tax rate on dividends irrespective of the tax status of the recipient shareholder.

This 'tax on distributed profits of domestic companies' is housed under a distinct part of the Indian Income Tax law[3] which overrides other portions of the law[4] and is stipulated to be "in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year" levied at a fixed rate of fifteen percent. Initially the taxpayers, including foreign investors found the scheme reasonable as it was fixed at 7.5% when the law was legislated. The rates, however, kept on climbing steadily making it uncompetitive, particularly in absence of specific provisions for availing foreign tax credit. DDT credit, however, is available to a resident

Indian parent receiving dividends from its Indian shareholding but only to the extent of discharging the DDT on parent's DDT liability.[5]

Reverting back to the classical dividend tax design, the Indian law stands amended effective from April 1, 2020 after which DDT has ceased to apply.[6] In contemporary sense, therefore, the debate on DDT may be academic. However, since the DDT regime has created challenges for the taxpayers in claiming tax treaty benefits, it is expedient to revisit its past application.

Juxtaposing DDT within the tax treaty framework

Even though challenges to constitutional validity of the DDT were raised by Indian shareholders,[7] the main objections to the levy of DDT were on account of non-resident shareholders of Indian companies, particularly their overseas parents. This is owing to the 15% DDT rate *vis-à-vis* 10% rate on dividend income in most Indian tax treaties, which is further reduced to 5% rate in some cases either in the treaty itself or under the most favored nation (MFN), a common phenomenon with regard to Indian tax treaties. In the event DDT is not considered as a tax on dividend and thus outside the tax treaty framework, neither the benefit of reduced tax rate is available to the non-resident shareholder nor is the credit of DDT available in the State of Residence. This was highlighted as a disincentive for foreign shareholding owing to the exponential rise in tax incidence.[8]

The Indian tax-administration distinguished DDT from a withholding tax on dividends. It relied upon the legal text of the law to take a position that DDT was an 'additional tax' on the Indian company and not a tax paid by the company on behalf of the shareholder.[9] Specific inclusion of DDT within certain treaties further embroiled the controversy. For illustration, the Protocol appended to the India-Hungary treaty[10] was relied upon to contend that India did not agree to DDT being a covered tax in absence of a specific inclusion within the treaty framework. Consequently, the tax treaty benefits available to the non-resident shareholder stood denied to the extent of DDT. In practical terms, the dividend income clause in Indian tax treaties was redundant to the extent of dividend income earned from India.

Recent Tax Tribunal Order

Whether DDT is identical or substantially similar to the treaty version of dividend tax, has been one question which has been plaguing the Indian courts for long. Even though the intrinsic nature of DDT was *inter alia* examined by the Indian Supreme Court,[11] the issue with regards to creditability under DTAA was not specifically addressed. The recent Tribunal verdict has addressed it in its recent order in the context of India-Germany treaty to conclude in the affirmative and extend the treaty benefit *qua* DDT.[12]

Examining the background leading to imposition of DDT and factoring the recent abolition of DDT, the Tribunal concluded that the "levy of DDT was merely for administrative conveniences and withdrawal of DDT is keeping in mind that revenue was across-the-board, irrespective of marginal rate, at which recipient is otherwise taxed." The Tribunal went beyond to declare, considering the objective of the avoidance of double taxation, "the liability to DDT under the Act which falls on the company may not be relevant when considering applicability of rates of dividend tax set out in the tax treaties". The Tribunal relied upon the Indian precedents[13] to conclude that the impact of tax treaties cannot be whittled away by unilateral changes in the domestic law and has directed to administration to ensure that the 10% rate under the India-

Germany treaty is observed.

Implications for tax treaty framework

The decision of the Tribunal is not the last word and certainly raises a “substantial question of law” leading to an appeal by the tax administration. It is safe to assume that the debate will be settled by superior courts, including the Supreme Court of India. Nonetheless, the DDT design has multiple implications for tax treaty framework, some of which are enumerated below.

1. The DDT design manifests the accentuating extent to which domestic laws and peculiarities of their design can arrest the taxpayers’ benefits available under the treaties. Here the treaty benefit was not made available, notwithstanding the common understanding that DDT is a tax on dividend.
2. India’s DDT design is a quintessential illustration of how tax treaties fail to address economic double taxation in absence of corresponding legal double taxation. There was no doubt that DDT leads to economic double taxation but its design as an additional tax on the distributing company instead of a tax on the recipient shareholder effectively outlawed the treaty benefit.
3. The DDT law, furthermore, reveals stark consequences of difference in negotiating powers of the treaty countries. To highlight the case of Hungary, which specifically got DDT included within its tax treaty *vis-à-vis*, Netherlands which officially clarified that it agrees with India to keep DDT outside the treaty framework.[14] It is also understood that many other Indian treaty partners, in parallel, refused to give double tax credit against DDT either by way of strictly interpreting domestic laws dealing with foreign tax credits or by way of administrative practices. This clearly put India’s treaty partners to disadvantage, besides, impacting India’s competitiveness to attract foreign direct investment.
4. The Tribunal highlights how, pragmatically, the world has not changed despite the pivotal declared by the Canadian Supreme Court in *Melford Developments*[15] which warned against unilateral domestic law changes which dilute the treaty provisions and still require judicial intervention to restate the treaty benefits.
5. At a domestic policy level, abolition of DDT has led to a different debate. With tax treaty benefit being available to most non-resident shareholders, including an upper limit of 10% on dividend income, it is argued that the traditional system leads to reverse discrimination against the resident individuals, many of whom would have to pay tax on dividend at the maximum rate of 30% and with surcharges as high as 42.5% for HNWI. The debate is further muddled if one looks at compares with other forms of investments, including Alternative Investment funds etc. Co-incidentally, India’s domestic law has been recently amended to introduce changes to exempt dividends earned by Sovereign Wealth Funds and Pension funds.[16] Though such changes are considered in the interest of larger public policy to attract such forms of FDI, it certainly makes the dividend regime, even for treaty participants complex and unwieldy. The introduction and abolition of DDT, therefore, reveals the quagmires of policy-framers and addressing trade-offs between residents and non-residents, such as horizonal equity considerations in this case.
6. At a treaty level, the abolition of DDT has led non-residents to rush to repatriate profits, which was a costly affair[17] It is anticipated that the abolition of DDT may ignite another the debate with the tax-administration which is closely examining the contours of beneficial ownership, juxtaposed with the treaty’s anti-avoidance Principal Purpose Test.

In short, the DDT law of India presents an intriguing case-study on the pragmatic interface between domestic laws and tax treaties and the taxpayers’ entitlements under the latter.

Views are personal.

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[1] Income Tax Act, 1961 (hereinafter referred as 'Act'), Section 115O to 115Q.

[2] Section 56(2)(i), Act taxes dividend as 'income for other sources' of a taxable person.

[3] Chapter XII-D, Act

[4] Section 115-O of the Act creates a charge of DDT carries, what is understood in common law as *non-obstante* clause, to provide that it shall have effect "[n]otwithstanding anything contained in any other provision of this Act".

[5] Section 115-O(1A), Act.

[6] Changes made vide Finance Act, 2020.

[7] The validity of the DDT was upheld by the Indian High Courts. See *Jayshree Tea and Industries Ltd. v. Union of India* (2002) 253 ITR 608 (Calcutta) available at https://indiankanoon.org/doc/1617131/ and *George Williamson (Assam) Ltd. v. Union of India* (2007) 292 ITR 322 (Gauhati) available at https://indiankanoon.org/doc/1626242/.

[8] For details, see Tarun Jain & Shreyash Shah, *Budget 2020: Contextualising cravings for abolition of Dividend Distribution Tax*, January 29, 2020, available at https://www.moneycontrol.com/news/economy/policy/budget-2020-contextualising-cravings-for-abolition-of-dividend-distribution-tax-4874911.html

[9] This position has resulted into DDT being characterised as an amorphous non-descript tax. For illustration, see, Tarun Jain, *Dividend Distribution Tax: A Rejoinder to 339 ITR (J) 52,* (2012) 343 ITR (J) 42-51 available at https://ssrn.com/abstract=2077968

[10] The relevant party of the Protocol to India-Hungary Treaty states "[w]hen the company paying the dividends is a resident of India the tax on distributed profits shall be deemed to be taxed in the hands of the shareholders and it shall not exceed 10 per cent of the gross amount of dividend."

[11] *Godrej and Boyce Manufacturing Co. Ltd. v. Deputy Commissioner of Income Tax* (2017) 394 ITR 449 (SC).

[12] *Giesecke & Devrient [India] Pvt Ltd v. Additional Commissioner of Income Tax* [Income Tax Appeal No. 7075/DEL/2017, order dated 13.10.2020] available at https://www.itat.gov.in/files/uploads/categoryImage/1602586537-7075.Giescke%20&%20Devrient.pdf

[13] *Director of Income Tax v. New Skies Satellite BV* (2016) 382 ITR 114 (Delhi) available at https://indiankanoon.org/doc/16626780/. It is noteworthy that this decision invokes upon the 'good faith' principle under the Vienna Convention on Law of Treaties to conclude such. This decision has further, *inter alia* observed that the court has rested its decision on "the inability of the

Parliament to effect amendments to international instruments and directly and logically, the illegality of any Executive action which seeks to apply domestic law amendments to the terms of the treaty, thereby indirectly, but effectively amending the treaty unilaterally."

[14] Decree No. IFZ 2012/54M dated February 28, 2012 issued by Dutch Directorate-General for Fiscal Affairs, International Fiscal Affairs.

[15] *R. v. Melford Development Inc.* (1982) 2 SCR 504, available at https://www.canlii.org/en/ca/scc/doc/1982/1982canlii201/1982canlii201.html

[16] Section 10(23FE), Act. The exemption is available effective from April 1, 2020 to income in the nature of dividend, interest or long-term capital gains.

[17] The move to consistently raise the DDT rates, earlier, meant a material cost for foreign investors to repatriate earnings give that until 2019, the effective corporate tax rates were as high as 35%. [Section 115BAA has been introduced in the Act to stipulate 22% corporate income tax rate for Indian companies from Financial Year 2019-20 onwards.] Thus, in the part, coupled with taxes on other forms of repatriation, such as share buy-back (under Section 115QA of the Act), etc. towards plugging tax avoidance, the DDT regime left foreign investors with trapped cash situation.

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