Dividend income from India - Tax treaty issues for non-resident shareholders

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Background

Prior to 1 April 2020, dividend income of non-resident shareholders of an Indian company was exempt from tax in India. Indian companies paid dividend distribution tax ('**DDT**') on the declared dividend. However, from 1 April 2020 onwards, dividend income of shareholders of an Indian company is taxable in India in the hands of such shareholders and Indian companies are required to withhold appropriate tax before making payment of dividend.

The rate of tax (also withholding tax) on dividend income of non-residents, as per Indian Income-tax Act, 1961 ('**Act**'), is 20% (plus applicable surcharge and cess). Having said that, as per section 90(2) of the Act, a taxpayer is permitted to apply the provisions of a tax treaty, if the such provisions are more beneficial than the provisions of the Act[1].

Prior to 1 April 2020, due to the tax exemption under the Act, the issue of claiming tax treaty benefits in India for Indian dividend income was not relevant. Resultantly, the jurisdiction or tax status of the non-resident shareholder of the Indian company was also not relevant. However, due to the change in taxability from 1 April 2020, various issues are being faced by non-resident shareholders seeking to avail relief under relevant Indian bilateral tax treaties. This article aims to provide insights into some of the typical situations and issues being faced.

Overview of taxation of dividend under India's tax treaties

India has signed double tax avoidance treaties with over 90 countries / jurisdictions. Generally, the tax rate on dividend income is lower under the tax treaties as compared to the Act.

Further, some of India's tax treaties contain a most favoured nation (MFN) clause. The MFN clause permits a qualifying tax resident to import / apply a lower tax rate or scope of taxable income from another qualifying Indian tax treaty[2].

Hence, it is in the interest of the non-resident shareholders to seek access to the applicable tax treaty and reduce their tax liability in India, if possible. Broadly speaking, the tax rates under some of India's popular tax treaties (without considering MFN clause), are as under:

Country	Tax rate on dividend income (all inclusive)
United States of America (USA)	15% / 25%, depending on facts
United Kingdom (UK), Singapore	10% / 15%, depending on facts
Belgium *(MFN clause)*	15%
France, Hungary, Netherlands, Switzerland, Sweden *(all with MFN clause)*	10%
Germany	10%
Portugal	10% / 15%, depending on facts
Mauritius	5% / 15%, depending on facts
Slovenia, Lithuania (both OECD members)	5% / 15%, depending on facts
Columbia (OECD Member)	5%

[1] The non-resident shareholder would need to furnish tax residency certificate (TRC) from tax authorities of its country of residence along with other documentation to claim tax treaty benefits in India.
[2] The language of each MFN clause varies, including whether its application is automatic or not

As can be observed from the above table, under certain Indian tax treaties, the tax rates on dividend income from India can be reduced from 20% (plus applicable surcharge and cess) to as low as 5%.

Having said that, the tax authorities can invoke[3] the provisions of India's General Anti-Avoidance Rule (GAAR) to deny the tax treaty benefit in India, if they find that the main purpose of the arrangement is to obtain an impermissible tax benefit in India considering the principle of substance over form.

Analysis of taxation of dividend income under select Indian tax treaties and issues thereunder

a. Shareholders of Indian company tax resident in Mauritius

Historically, Mauritius has been one of the most popular jurisdictions for routing investments to India. Under the India-Mauritius tax treaty, rate of tax on dividend is as under:

- 5%, if the beneficial owner is a Mauritius company which holds directly at least 10% capital of the Indian company paying the dividends; and
- 15% in all other cases.

It may be noted that the Multilateral Instrument (MLI) does not yet apply to the India-Mauritius tax treaty as Mauritius has not covered the same while ratifying the MLI. Accordingly, the principal purpose test (PPT) under the MLI does not apply to the India-Mauritius tax treaty.

Coupled with the tax regime in Mauritius, Mauritius continues to be a favoured jurisdiction for making investments in the shares of an Indian company, especially where more than 10% shares are intended to be held. Having said that, the provisions of India's GAAR should be analysed before structuring investments through Mauritius. Also, if the MLI becomes applicable to the India-Mauritius tax treaty in the future, requirement of economic and commercial substance under the PPT test will be crucial for availing tax treaty benefits in India.

b. Shareholders of Indian company tax resident in USA

Under the India-USA tax treaty, rate of tax on dividend is as under:

- 15%, if the beneficial owner is a USA company which owns at least 10% of the voting stock of the Indian company paying the dividends; and
- 25% in all other cases.

However, the following issues have to be considered before granting the benefit of India-USA tax treaty in India:

- Article 24: Limitation on benefits (LOB): To avail tax treaty benefit, the USA tax resident should be engaged in active conduct of trade or business in USA - other than making or managing investments[4]. Further, the income from India should be derived in connection with or incidental to such trade or business.

  If the above conditions are not satisfied, the USA tax resident needs to ensure that:
  - more than 50% of its beneficial interest is owned directly or indirect by USA tax residents or citizens; and
  - its income is not substantially used to directly or indirectly meet liabilities to non-USA tax residents or citizens.

[3] Subject to meeting prescribed thresholds and obtaining necessary approvals
[4] Activities of banks and insurance companies are excluded.

If the LOB clause is not satisfied, the benefit of India-USA tax treaty cannot be availed in India (unless determined otherwise by competent authority of India).

- Limited Liability Companies (LLCs): Many LLCs which are shareholders in Indian companies are pass-through entities in the USA under USA tax law i.e. disregarded for tax purposes in USA. In other words, the income of such LLCs is taxable in the hands of its owners and not in the hands of the LLC itself. This casts a question on the LLC qualifying as a 'resident' under the India-USA tax treaty since it is technically not "liable to tax" in the USA by itself.

  Based on certain judicial precedents, it may be possible to take a stand that if the owners of the LLC, in whose hands the income of the LLC is taxed, are also residents of the USA and meet the conditions of the India-USA tax treaty (including the LOB clause), then proportionate tax treaty benefit should be granted to the USA LLC in India. However, litigation with Indian tax authorities cannot be ruled out on such stand.

It may be noted that the MLI does not yet apply to the India-USA tax treaty. However, GAAR can still be invoked to deny the tax treaty benefit in India.

c. Shareholders of Indian company tax resident in UK or Singapore

Under the India-UK tax treaty, essentially the rate of tax on dividend from an Indian company is 10% (15% tax rate is provided for very limited circumstances). Under the India-Singapore tax treaty, the rate of tax on dividend is as under:

- 10%, if the beneficial owner is a Singapore company which owns at least 25% of the shares of the Indian company paying the dividends;
- 15% in all other cases.

In addition to the risk of invocation of GAAR, since both India-UK tax treaty and India-Singapore tax treaty are modified by the MLI, even the PPT test will apply. Accordingly, the benefit of lower tax rate under these tax treaties may not be granted 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 resulting in that benefit directly or indirectly.

The benefit would nevertheless be granted if it is considered to be in accordance with the object and purpose of the relevant provisions of the tax treaties.

As the PPT is a subjective test, commercial and economic substance of the UK / Singapore shareholder of the Indian company should be tested before availing tax treaty benefit in India.

d. Shareholders of Indian company tax resident in Netherlands

Under the India-Netherlands tax treaty, the rate of tax on dividend from an Indian company is 10%. However, the possibility to invoke the MFN clause under the said tax treaty and avail a lower tax rate of 5% on such dividend income exists, as was discussed before the Delhi High Court in the case of a Netherlands taxpayer[5]. A brief summary of the case is as under:

a. The taxpayer was a tax resident of Netherlands and a shareholder of an Indian company which was making payment of dividend to the taxpayer post abolishment of DDT.

[5] Concentrix Services Netherlands B.V. [W.P.(C) 9051/2020]

b. The tax rate on dividend income under India-Netherlands tax treaty is 10%. However, the taxpayer made an application to the Indian tax authorities seeking to invoke the MFN clause under the India-Netherlands tax treaty (signed in 1989). The taxpayer contended that the lower tax rate of 5% for dividend income under India's tax treaties with Slovenia (signed in 2003), Lithuania (signed in 2011) and Columbia (signed in 2011) would be imported into the India-Netherlands tax treaty under the MFN clause as these countries are OECD members as on date of the application.
c. The tax authorities denied the application of lower tax rate of 5% on the ground that Slovenia, Lithuania and Columbia were not OECD members when India signed the tax treaties with them. Slovenia became an OECD member in August 2010, Lithuania became an OECD member in July 2018 and Columbia became an OECD member in April 2020. Hence, the intention was not to allow access to lower tax rates agreed with them under the MFN clause once they became OECD members.
d. The Delhi High Court however held that the benefit of lower tax rate of 5% for dividend income under these tax treaties will be available to the Netherlands taxpayer, as these countries are OECD members when the MFN clause is sought to be invoked. The Delhi High Court also placed reliance on the Decree issued by the Netherlands authorities which stated that the lower tax rate of 5% for dividend income under the India-Slovenia tax treaty would apply to the India-Netherlands tax treaty. Hence, it was held that India cannot take a contrary stand in light of the decree and principles of interpretation of tax treaties.
e. Accordingly, the High Court did not agree with the arguments of the tax authorities that the status of OECD membership as on date of signing tax treaty with India is relevant for permitting access under the MFN clause.

While currently the matter is decided in favour of the Netherlands taxpayers, a few points require consideration:

- The tax authorities may seek to challenge the Delhi Court judgment before the Supreme Court of India. The issue will be settled i.e. binding across India only after the Supreme Court rules over it. Till then, the possibility of another High Court taking a contrary view cannot be ruled out.
- The possibility of the income-tax authorities not accepting the Delhi High Court judgment in assessment proceedings also cannot be ruled out. In that situation, the option of invoking Mutual Agreement Procedure (MAP) may have to be explored or the contrary views of Indian tax authorities challenged in Indian courts.
- The impact of Indian GAAR and PPT test under India-Netherlands tax treaty would need to be analysed.
- The 5% tax rate on dividend under India-Slovenia tax treaty and India-Lithuania tax treaty is available only if the beneficial owner is a company which holds directly at least 10% capital of Indian company paying the dividends. Such condition is not provided under the India-Netherlands tax treaty. It is not clear whether this condition needs to also be imported while invoking MFN clause under the India-Netherlands tax treaty.
- Further, the condition of 5% tax rate on dividend income under India-Slovenia tax treaty is modified by Article 8 of MLI which mandatorily requires the 10% shareholding to be met throughout a 365 day period (including the date of payment of dividend). Article 8 of the MLI does not apply to India-Netherlands tax treaty. Again, it is not clear whether conditions introduced by Article 8 on the MLI in the India-Slovenia tax treaty would also need to be imported while invoking MFN clause under the India-Netherlands tax treaty.

e. Shareholders of Indian company resident in Switzerland

Under the India-Switzerland tax treaty, the rate of tax on dividend from an Indian company is 10%. However, the possibility to invoke the MFN clause under the said tax treaty and avail a lower tax rate of 5% on such dividend income exists.

Subsequent to the judgment in case of the Netherlands taxpayer (referred above), the Delhi High Court in case of Nestle SA[6] gave similar access to lower tax rate of 5% for dividend income to Switzerland taxpayers, under the MFN clause of India-Switzerland tax treaty.

In light of this direct Delhi High Court judgment, relying on the India-Lithuania and India-Columbia tax treaties, the Swiss tax authorities have officially notified[7] Swiss taxpayers that:

- the lower tax rate of 5% is applicable on receipt of dividend income from Indian companies
- foreign tax credit in Switzerland on such income will be permitted only to the extent of 5%
- similar reciprocity is expected from the Indian tax authorities in this matter.

It may be noted the MLI does not apply to the India-Switzerland tax treaty. Hence, the PPT test and Article 8 of MLI, etc. should not impact the India-Switzerland tax treaty. However, the points for consideration mentioned above in context of Netherlands will suitably apply even for Swiss taxpayers.

In fact, a similar analysis would need to be undertaken for other countries with similar MFN clauses in their tax treaties with India.

f. Non-resident shareholders of Indian company tax resident in Cayman Islands and British Virgin Islands (BVI):

India has not signed double tax avoidance treaties with Cayman Islands and BVI. Accordingly, residents of these countries are required to pay tax on their dividend income from India under the Act i.e. at 20% (plus applicable surcharge and cess).

Situations have arisen where such residents are exploring the idea to redomicile themselves to other jurisdictions, especially Mauritius which is not only a business-friendly jurisdiction but also provides for an overall favoured tax regime (including tax treaty with India). Redomicile is essentially where a company moves its 'domicile' (or place of incorporation) from one jurisdiction to another by changing the country under whose laws it is registered or incorporated, whilst maintaining the same legal identity. Ideally, redomicile of the non-resident shareholder should not result in a transfer of shares of the Indian company and should not result in a capital gains tax liability in India as the legal person owning the shares remains the same.

A question therefore arises is whether such re-domiciliation will impact claim of any future tax treaty benefit in India i.e. whether the tax treaty benefit can be challenged on the ground of treaty-shopping for tax evasion / avoidance purposes.

Recently the Mumbai bench of the Income-tax Appellate Tribunal (ITAT) in case of **Asia Today Limited**[8] held:

- that there can be various dynamic and constantly evolving business reasons and justifications for re-domiciliation especially if existing place of domicile inhibits future business or prospects in some way;

[6] (W.P. (C) 3243/2021)
[7] Issued by Federal Department of Finance FDF
[8] [TS – 620-ITAT-2021 (Mum)]

- Re-domiciliation of offshore companies are facts of life.
- A re-domiciliation of the company by itself cannot lead to denial of treaty entitlements of the jurisdiction where the company has re-domiciled.
- It could however trigger a detailed examination of the re-domiciled company being actually fiscally domiciled in that jurisdiction.
- Where the taxpayer had redomiciled from BVI to Mauritius 2 decades ago, denying tax treaty without any material on record was not justified.

Hence, if there are strong business and commercial reasons to redomicile companies based out of Cayman Islands or BVI, then claiming tax treaty benefit under India's tax treaty with the subsequent jurisdiction may be possible. The possibility of litigation with Indian tax authorities cannot, however, be ruled out especially under GAAR and PPT test, as applicable.

Conclusion

Taxation of dividend income in India in hands of non-resident taxpayers is likely to witness various issues and even litigation going forward (especially on access to MFN). The issue gets further compounded for non-resident taxpayers if higher taxes are withheld in India and corresponding tax credit is not granted in their country of residence (e.g. Switzerland). Such taxpayers would need to consider claiming a refund of higher withheld taxes in their Indian tax returns.

Non-resident taxpayers seeking to avail tax treaty benefit in India are required to obtain a Permanent Account Number (PAN) (akin to tax identification / registration number) and file tax returns in India. Once the tax return has been filed with a lower rate of tax, it is possible that the tax return may be routinely selected for scrutiny.

Accordingly, before adopting a position on the taxability of dividend income from India and filing of Indian tax returns, a careful analysis should be carried out under the Act and applicable tax treaty in light of various facts and documents. This exercise should also assist the taxpayer in substantiating is tax position before the Indian tax authorities during assessment proceedings and mitigate potential penal consequences.