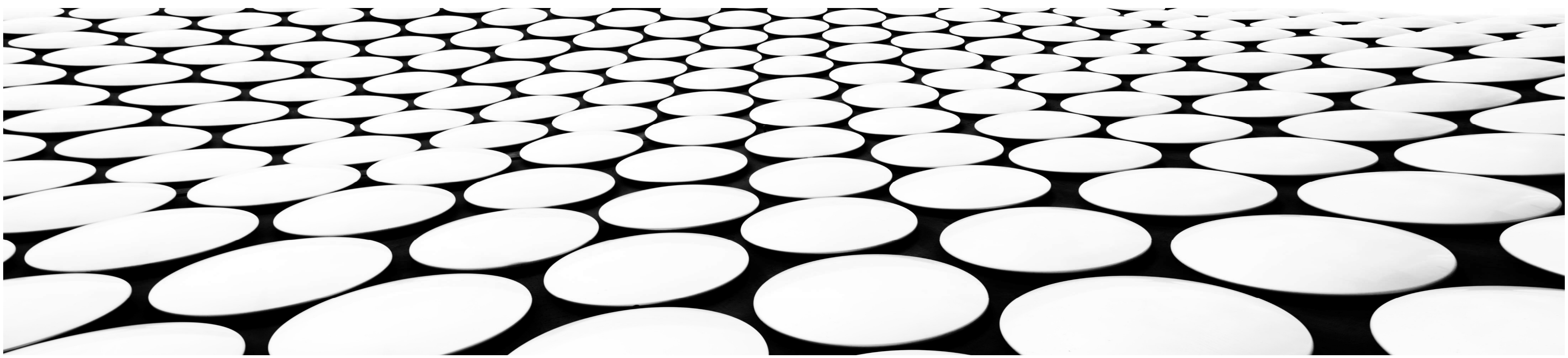
DIVIDENDS

CA (ADV) BHAVYA BANSAL GOYAL



CONTENTS

EQUITY VS DEBT

EQUITY VS DEBT

- There are two types of capital normally employed by shareholders
- Equity share capital;
- Debt capital
- Payments made under the **equity** instruments are usually classified as **dividends** whereas payments made under **debt** instruments are usually classified as interest.
- From the company's view point, debt is preferred over equity as a high debt-equity ratio can reduce the tax on business profits:

Particulars	Cost of debt	Cost of equity
Nature of return	Interest paid on debt	Dividend paid on equity
Max tax rate as per OECD Model	10%	5%/ 15%
Deductible as expense to company	Yes	No

DIVIDENDS-INCOME TAX ACT, 1961

DEFINITION

- **Section 2(24)(ii) says income includes Dividend;**
- **Section 2(22) provides an inclusive definition of dividends:**

  a. Distribution of assets
  b. Distribution of debentures & distribution of bonus shares to preference shareholders
  c. Distribution on liquidation
  d. Reduction of capital
  e. Loan to the beneficial owner of shares holding >10% of voting power or to concern in which shareholder has substantial interest

DEEMED DIVIDEND

- For applicability of section 2(22)(e) there must be a payment by way of advance or loan {DCIT vs. Veena Goyal – [2020] 119 taxmann.com 362}
- Shareholding in lender company and substantial interest in borrower company to be checked at the time of advancement of loan { ACIT vs. Gurdeep Singh – [2020] 117 taxmann.com 451}
- "Shareholder", means beneficial owner of shares {National Travel Service vs. CIT (Supreme Court)}
- Not applicable in case of commercial transactions {Circular No. 19/2017 dated 12 June 2017}
- Amount received for providing corporate guarantee, not deemed dividend u/s 2(22)(e) {DCIT vs. Accel Limited – [2020] 118 taxmann.com 103 (Madras)}
- will not apply to an advance or loan made to a shareholder or a concern (in which shareholder has substantial interest) by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company PCIT vs. Mohan Bhagwatprasad Agrawal – [2020] 115 taxmann.com 69 (Gujarat)

HISTORY ON TAXABILITY

- 1997-Withholding Tax
- 2002-DDT
- 2003-Withholding Tax
- 2019-DDT

2020- Withholding tax

RESIDENT SHAREHOLDER

- Domestic companies shall be liable to deduct tax under Section 194 at the rate of 10%;
- If aggregate amount of dividend distributed or paid during the financial year to a shareholder exceeds Rs. 5,000;
- Dividend received during the financial year 2020-21 and onwards shall now be taxable in the hands of the shareholders

NON-RESIDENT SHAREHOLDER

- The dividend income shall be taxable in India as per provisions of the Act or as per relevant DTAA, whichever is more beneficial;
- A non-resident generally invests in India either directly as private equity investors or as Foreign Portfolio Investors (FPIs);
- The dividend is payable to a non-resident or a foreign company, the tax shall be deducted under Section 195 in accordance with relevant DTAA
- Tax Rate: FPIs & NRIs- 20% and Offshore banking unit-10%

WITHHOLDING RATE UNDER DTAAS

- Croatia
- France*
- HongKong
- Lithuania
- Malaysia
- Mauritius
- Nepal
- Netherlands*
- Saudi Arabia
- Sweden*
- Switzerland*

5% withholding

- Botswana
- Ethiopia
- Mozambique
- Sri Lanka

7.5% withholding

- Austria
- Bangladesh
- China
- Cyprus
- Czech Republic
- Germany
- Indonesia
- Ireland

10% withholding

CHARACTERIZATION

- Profit & Gains from business & profession
- Income from other sources

Recharacterization of dividend: In a Danish case the dividend were reclassified as royalties by SKAT. However, National Tax Tribunal ruled in favour of taxpayer and found that there was no basis with the tax authorities for reclassifying the dividend to royalties

TAXABILITY

- **Section 8 –Dividend Income**
  - Dividend is deemed to be the income of the tax year in which it **is declared, distributed or paid whichever is earlier**.
  - Interim dividend shall be deemed to be the income of the tax year in which the amount of such dividend is unconditionally made available by the company to the shareholder who is entitled to it.

DIVIDENDS-ARTICLE 10

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

DIVIDEND – ARTICLE 10- OVERVIEW

	Article 10	Content
Sharing of taxing rights	Article 10(1)	Taxability of dividend in resident country
	Article 10(2)	Taxability of dividend in source country
Definition	Article 10(3)	Meaning of 'dividend'
PE scenario	Article 10(4)	PE scenario
Extraterritorial taxation	Article 10(5)	Extraterritorial taxation

ARTICLE 10(1)

- "Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State"

- UN Model reproduces Article 10(1) of the OECD Model

- 'May be taxed' Right to tax dividend paid by resident of one country to the resident of an other country;
- Country of residence of dividend receiver has the first right to tax
- Right is not exclusive Source Country may also tax it in certain circumstances

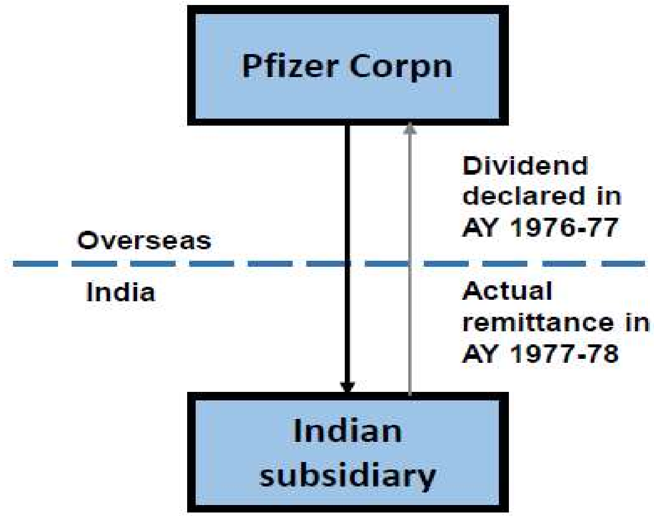
- Dividend 'paid' has a very wide meaning since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom

“PAID” WHEN RECIPIENT NON RESIDENT

Pfizer Corpn.

[2003] 259 ITR 391(Bombay)

- Pfizer Corpn, a non-resident company received dividend from its subsidiary in India
- Dividends were declared in FY1975-76
- Actual remittances with permission of RBI were made in subsequent assessment years
- Tax authority argued that dividend income accrued to assessee on the date of its declaration
- Assessee argued that it accrued only when the RBI granted approval to remit them



OECD DTC

The 2017 version of the OECD Model Treaty (Article 10(2)) states that where the ‘beneficial owner’ is a resident of the other contracting state, then the tax of the source state should not exceed:

i. 5% of the gross amount of the dividends where the ‘beneficial owner’ is a company and holds at least 25% of the capital paying the dividend, and

ii. 15% of the gross amount of the dividends in all other cases.

In practice both the tax rate percentage (commonly referred to as the ‘withholding tax’) and the beneficial owner threshold percentage vary (in this respect reference is often made to ‘voting’ shares).

ARTICLE 10(2)

However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the **capital** of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

CAPITAL

- “Capital" has not been defined as per the UN Commentary -Reference has been drawn to include the following
- Capital means paid up capital shown at face value in the Company’s Balance Sheet
- Reserves such as Share Premium not be taken into account
- Differences in voting rights, types of shares etc. not to be considered
- Amounts treated as capital under ‘thin capitalization’ to be considered
- In case of bodies having no share capital, like Company limited by guarantee, capital means total of all the contributions to the body which are taken into account for the purpose of distributing profits
- Some DTAAs use the term voting power instead of capital. This means equity shares only

ARTICLE 8 OF MLI

As per Article 8 of the Multilateral Convention:

"Provisions of a Covered Tax Agreement that exempt dividends paid by a company which is a resident of a Contracting Jurisdiction from tax or that limit the rate at which such dividends may be taxed, provided that the beneficial owner or the recipient is a company which is a resident of the other Contracting Jurisdiction and which owns, holds or controls more than a certain amount of the capital, shares, stock, voting power, voting rights or similar ownership interests of the company paying the dividends, shall apply only if the ownership conditions described in those provisions are met throughout a 365 day period that includes the day of the payment of the dividends"

ARTICLE 8 OF MLI

Scope of Article 8

- Minimum Shareholding period of 365 days
- Without modifying element such a tax rates, ownership threshold and form holding
- Wherein treaties exempts or limit rate of tax on dividend subject to conditions

Conditions

- Recipient or Beneficial owner of dividend is a company which is a resident of other contracting state and
- Owns, holds or controls more than certain amount of the capital, shares, voting power of payer company

Scope Limitation

- Article 8 not applicable where changes in ownership result directly from a Corporate reorganisation

OTHER IMPLICATIONS

- PPT
- LOB
- GAAR

ARTICLE 10(3)

- Definition of “dividend” under the tax treaty
- “The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.”

ARTICLE 10(3)

Treated as dividend

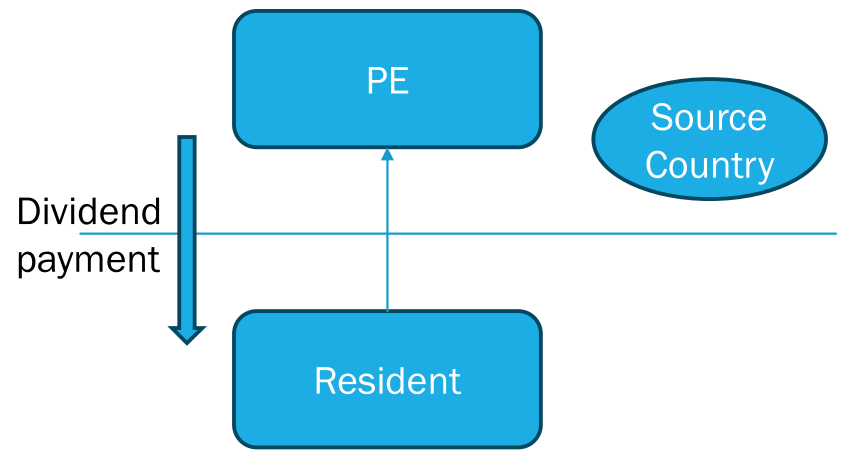
- Distributions of profits by Limited Liability Companies, Co-operative Societies
- Distribution on capital reduction and profits on liquidation
- Issue of Bonus Shares is treated as dividend as it is "other corporate rights"
- Purely contractual rights subjected to same tax treatment as income from shares

Not treated as dividend

- Distributions of profits by partnership
- Interest on convertible debentures (before conversion)
- Debt-claims participating in profits
- Distributions by a Company which has the effect of reducing the membership rights, for instance, payments constituting reimbursement of capital in any form

ARTICLE 10 (4)

The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.



ARTICLE 10(4)

- Meaning of the term effectively connected
- The term effectively connected has not been defined in the UN Model
- Mere recording of shareholding in the books of PE without any business operation, not ‘effectively connected’
- Effectively connected with a PE or fixed base may be determined by the following:
  - Forms part of the assets of PE
  - Enhances economic strength of the PE
  - Claim connected in form and substance
  - Really connected rather than legally connected
  - It creates a right which gives right to dividend
- For E.g. Citibank USA has a branch in India which advances a loan to Indian Co. against security of shares. Therefore, since the shares are held by Citibank India and it receives dividend. i.e. the PE has economic ownership to exploit the asset. Such dividend shall be “effectively connected” with the PE in India and hence, taxed as Business Income.

ARTICLE 10(5) EXTRA TERRITORIAL

Article 10(5) prohibits country of source from taxing undistributed profits of a company resident of other country even if the profits were wholly, mainly or partly derived from sources within the country of source.

BENEFICIAL OWNERSHIP ("BO")

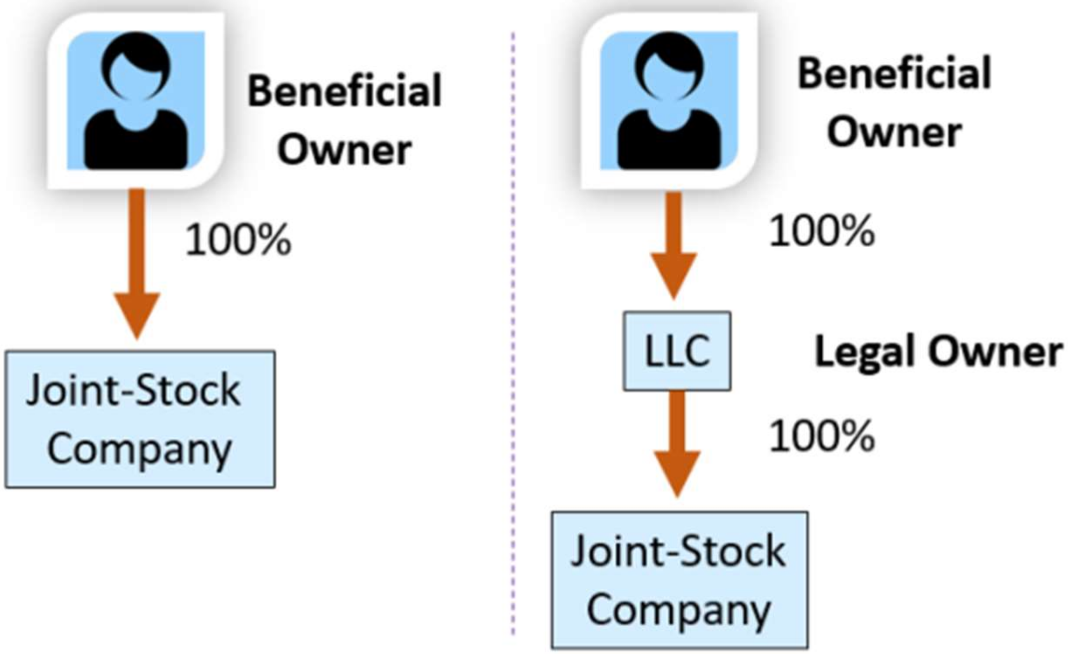
- Access to the reduced withholding rates or exemptions in articles 10 through 12 depends also on the recipient being recognized as the BO.

- The recipient of a dividend, interest, or royalty is the 'beneficial owner' of the payment when he has the right to use and enjoy the dividend, interest, or royalty, unconstrained by a contractual or legal obligation to pass on the payment received to another person

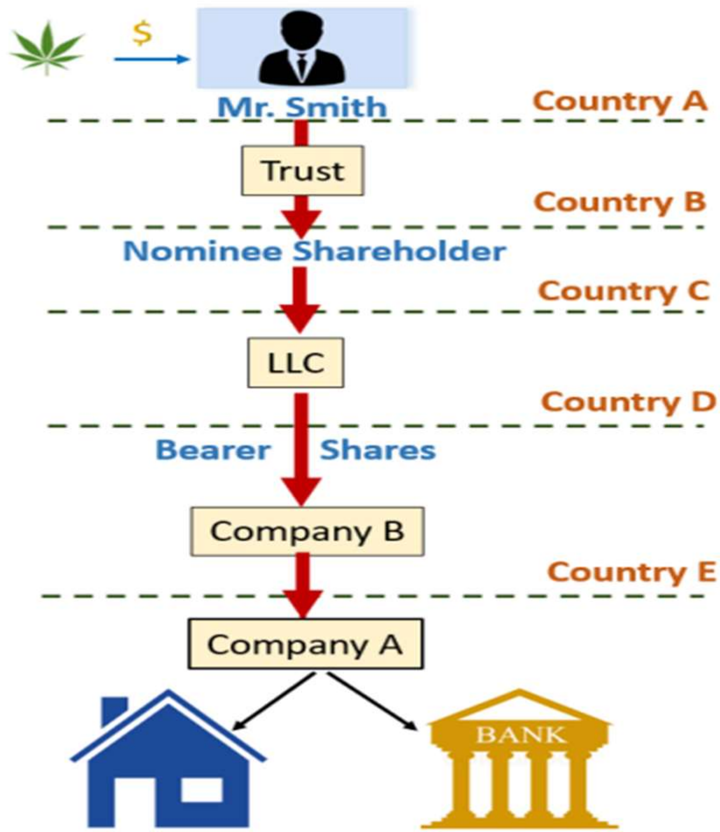
- rules out the possibility of considering as 'beneficial owners' persons acting as fiduciaries, agents, or nominees

- The meaning of the term 'beneficial owner' is discussed in paragraphs 12.1 to 12.7 of the commentary to Article 10 (2017 version) (and the equivalents in the Article 11 and 12 commentaries).

BO VS A LEGAL OWNER



COMPLEX SYSTEM OF LEGAL ENTITIES



BENEFICIAL OWNERSHIP

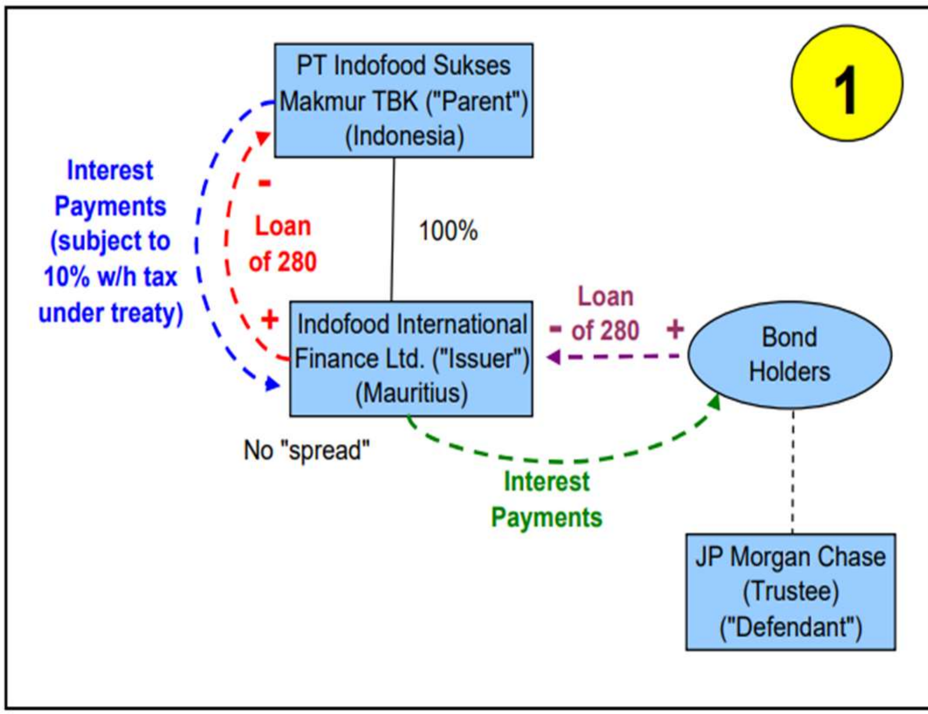
- Register maintained on beneficial ownership eg UK, India

- https://www.oecd.org/tax/transparency/beneficial-ownership-toolkit.pdf

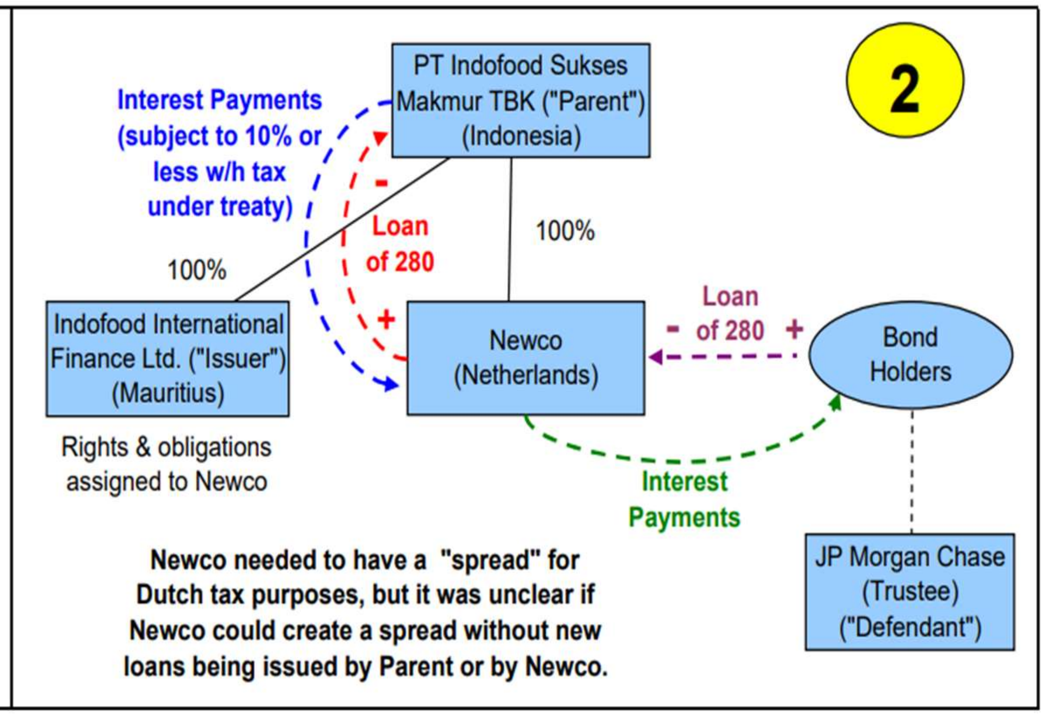
- Automatic exchange of information-As part of the Common Reporting Standard (CRS), committed jurisdictions are required to obtain identification information about applicable financial institutions' account holders and controlling persons.

INDOFOOD INTERNATIONAL FINANCE LTD V JP MORGAN CHASE BANK

Existing Structure



Hypothetical Structure



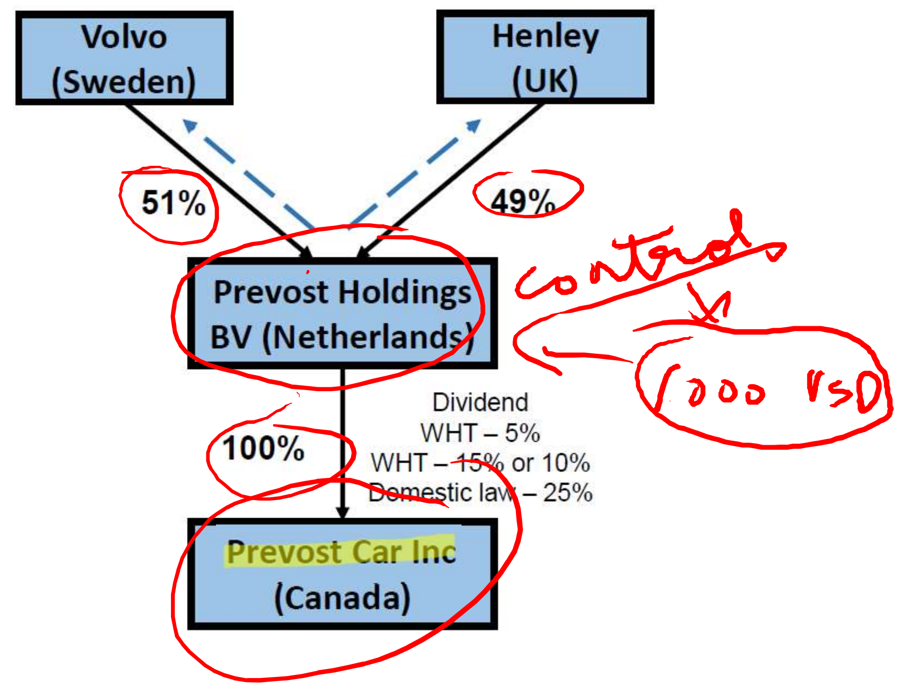
INDOFOOD INTERNATIONAL FINANCE LTD V JP MORGAN CHASE BANK

- The Court of Appeal relied heavily on the commentary to the OECD Model Treaty;
- Paragraph 9 of the OECD commentary to article 11:
- *"The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "**paid to a resident"** as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention."*
- under an 'international fiscal meaning', beneficial ownership is to be determined by reference to a test which requires that the recipient 'enjoy the full privilege to directly benefit from the income'.

PREVOST CAR INC.

Prevost Car Inc.
[2008 TCC 231]

- Prevost Car Inc (Prevost) had a sole shareholder i.e. Prevost Holding B.V. (resident in the Netherlands) (HoldCo)
- Hold Co distributed the dividends to Volvo Bus Corporation (resident in Sweden) (Volvo) and Henleys Group PLC (resident in UK) (Henleys)
- Volvo and Henleys held 51% and 49% respectively in Hold Co by virtue of a share subscription agreement between them (Hold Co was not a party to such agreement)
- Holdco had no employees in the Netherlands and no assets other than its investment in the shares of Prevost



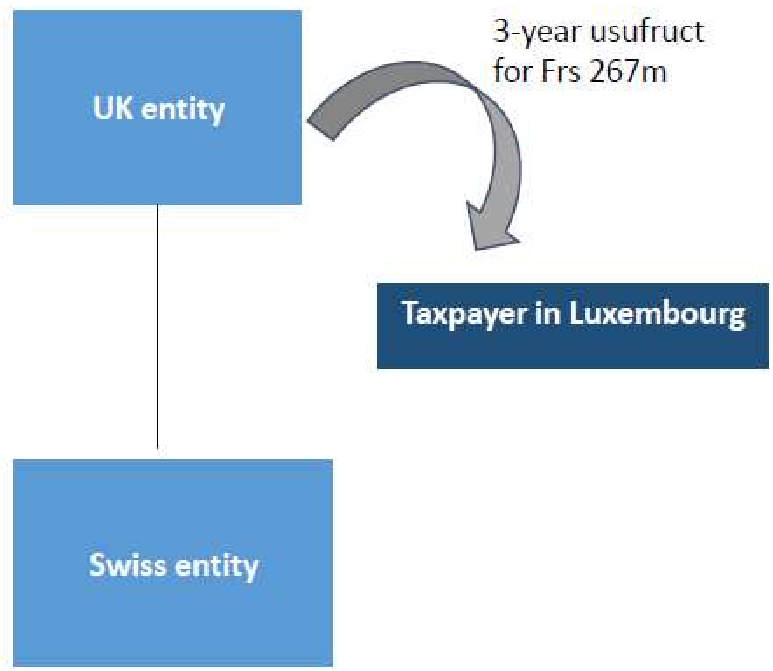
VELCRO CANADA INC V THE QUEEN (2012 TCC 57)

- This case involved royalty payments made by a Canadian company to a Dutch intermediate
- **Q. -Dutch company was the beneficial owner of such royalties?**
- It was noted that the Dutch company did not simply collect and immediately forward to the Antilles IP company a 90% share of the royalties collected from Velcro Canada;
- The royalty funds were mingled with other funds from other sources and sometimes converted into a different currency
- Concluded that the Dutch company also had control over the royalties and so the test of beneficial ownership had been met.

A. SARL V FEDERAL TAX ADMINISTRATION

Swiss Federal court

- The taxpayer (Luxembourg company)received certain shares of a Swiss entity from a UK based entity under the Stock Lending Arrangements
- The said arrangements provided that in the event of dividend payment by the Swiss company, the taxpayer would be obliged to make a compensation payment of an equal amount to the UK entity



CASE LAWS ON BENEFICIAL OWNERSHIP

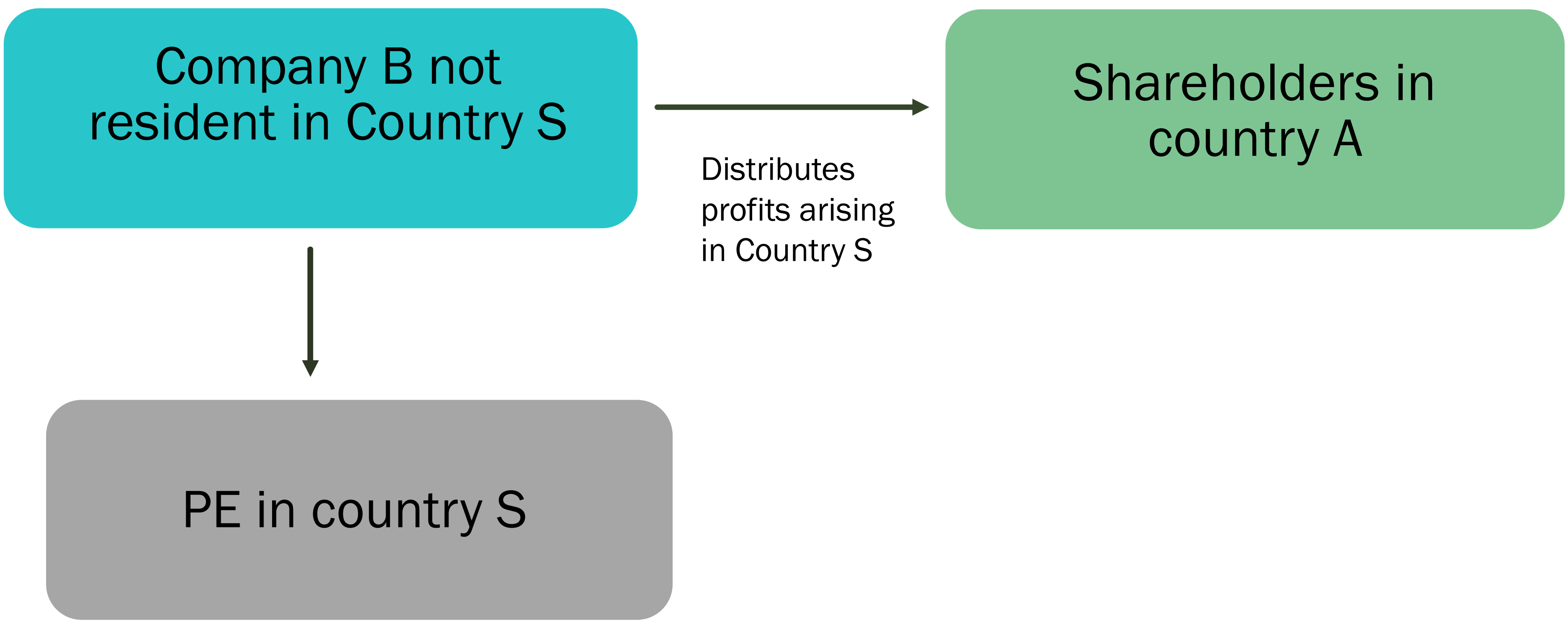
- *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] STC 1195- , a subsidiary company, which issued loan notes to various bond holders, had a back to back loan agreement with its parent company. As part of the loan agreement, the subsidiary was bound to pay the bond holders whatever interest amounts were received from its parent company. The subsidiary therefore had no power of disposition over the funds received from the parent company and thus was held not to be the beneficial owner thereof.
- Canadian case of *Prévost Car Inc. v The Queen* (2008 TCC 231, affirmed on appeal 2009 FCA 57);
- *Velcro Canada Inc v The Queen* (2012 TCC 57);
- *Re Swiss Swaps Case* I/A (2C-364,377 and 895/2012) (18 ITLR 138);
- *X Bank v Federal Tax Administration (beneficial ownership)*[2018] (21 ITLR 285)
- *Government Pension Investment Fund v Revenue Agency* (22 ITLR 701)-Italian case

BO-COMMON POINTS

Dividend, Interest, Royalty

- assumed both the risk and control of the dividends
- discretion as to the application
- did not simply collect and immediately forward remit forward
- income for its benefit
- assumed some conventional commercial risks with respect to the payments

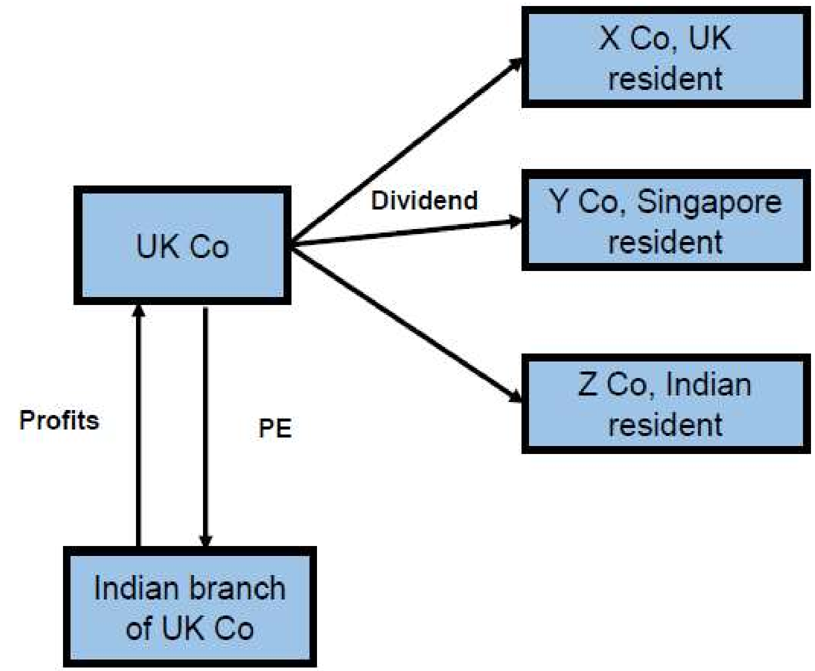
EXAMPLE


Company B not resident in Country S
Distributes profits arising in Country S
Shareholders in country A
PE in country S

CASE STUDY

- A UK Co has a branch in India carrying out business operations
- All of UK profits are attributable to the Indian branch
- UK Co declares dividend out of the profits accruing in India to its shareholders.

Can India tax the dividend?



QUIZ

- Which section provides for deduction of tax at source on distribution or payment of dividend by an Indian Company?
- Article 10 (1) gives right to **Source or Resident** state?
- What is the meaning of **Beneficial Ownership**?
- What did the case of **Pzifer** hold?
- Can **distribution of profits by partnership** be treated as dividend?
- As per section 2(22), dividend does not include ______ _.
  a) Any distribution if such distribution entails the release of all or any part of the assets of the company to the extent of accumulated profits of the company
  b) Any distribution made on liquidation of accompany to the extent of accumulated profits of the company
  c) Any distribution on the reduction of capital of a company to the extent of accumulated profits of the company
  d) Any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A of the Companies Act, 1956

QUERIES

YOUR

QUESTIONS

PLEASE !!!

THANK YOU!

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