Taxation of Dividend and Interest

NALSAR University of Law, M.A. (International Taxation)

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Agenda

1. Key characteristics of Dividend and Interest
2. Dividend - Chronology and scope of domestic taxation
3. Dividend taxation - Non-resident's perspective
4. Overview of interest and domestic taxation of interest
5. Interest - Taxation for non-residents
6. Thin capitalization and other aspects

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Dividend and Interest - Key characteristics

- An increase in economic interdependence between countries is leading to a movement of capital and resources
- Further, the legal, regulatory and tax considerations have a bearing on the choice of instrument an entity resorts to for the purpose of raising capital. Few key differences between interest and dividend are as under:

- Dividend is a mode of distribution of profits of the Company to the shareholders
- Quantum of dividend income cannot be fixed and is dependent on the earnings of the Company and the future plans envisaged
- No inherent right and absence of certainty that dividend shall be paid every year by a Company

Interest

- A mode of compensating a lender of money/capital for lending out money
- A fixed periodic payout as compared to a dividend
- Claim of interest is a secured debt on the Company
- The lender has an inherent right to receive the interest

Meaning of dividend under the Income Tax Act, 1961 ("Act")

Section 2(22) of the Act

- any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails all or any part of the assets of the company
- any distribution to shareholders of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not
- any distribution made to the shareholders on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not
- any distribution to the shareholders on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether such accumulated profits have been capitalised or not
- any advance or loan to a shareholder, being a person who is the beneficial owner of equity shares holding not less than ten per cent of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits

Scope of taxation of Dividend

Dividends are taxable in the year in which dividend is declared, distributed or paid. Dividend includes interim dividend

ROR taxation

ROR are taxable on dividends received from an Indian company as well as from foreign companies

NR and RNOR taxation

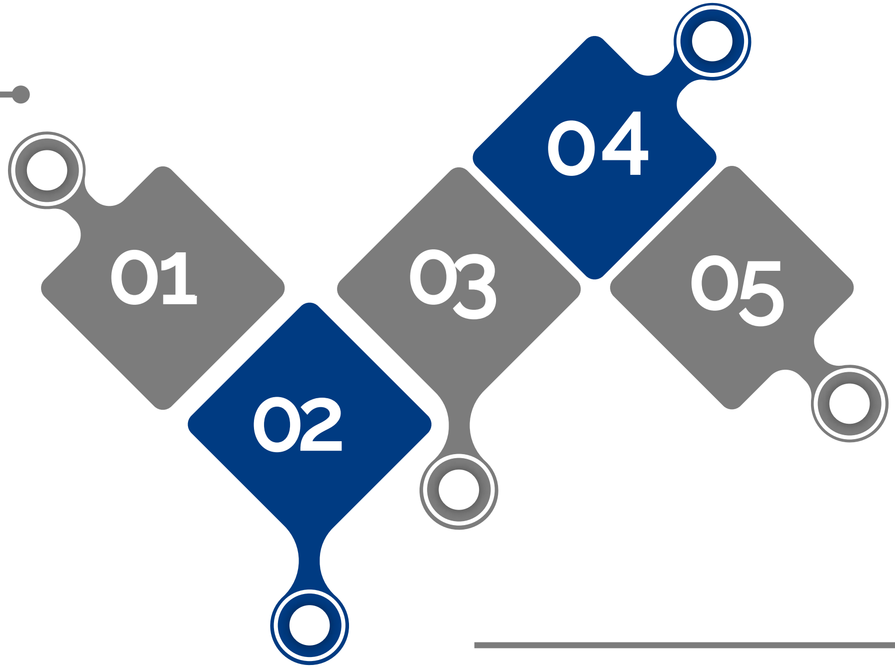
NR and RNOR are taxed only on:

a) Dividends received from Indian companies;

b) Dividends received in India

Evolution and History of Taxation of Dividend

Chronology



1961

Shareholder level taxation

1997

DDT Regime

2002

Shareholder level taxation

2003

DDT Regime

2020

Shareholder level taxation

Taxation regime for dividend subject to DDT

Dividend subject to DDT is exempt from tax in hands of investors under Section 10(34) of the Act - Provided that it does not apply to dividend chargeable to tax under Section 115BBDA of the Act

Section 115BBDA is a non-obstante provision applicable to taxpayers including individuals, HUF and firms

Taxation at the rate of 10% on dividend in excess of INR 1 million received from domestic companies

Practically, only if dividend is less than INR 1 million, exemption under Section 10(34) is available

No deduction allowable against the dividend income to the taxpayer in respect of any allowance or expenditure

An overview of dividend taxation

A distribution mechanism employed by Companies to distribute profits

Distribution of dividend is out of post tax profits

Effective tax cost higher because of double taxation – In the hands of the company and the shareholder

No tax deduction as such allowable on amounts distributed as dividend

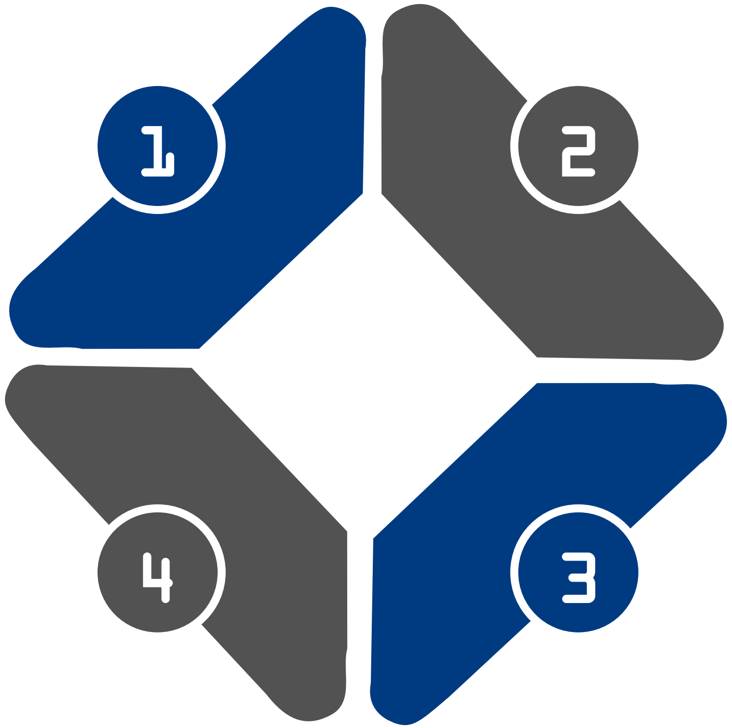
Economic burden of taxes borne by the investor leading to lower return on investment

Dividend Distribution Tax

01	Technically, investors are required to discharge tax on the dividend. However, liability imposed on the Companies for ease of collection and corresponding exemptions provided to investors
02	Provisions enshrined in Section 115-O of the Act
03	Non-obstante clause overriding other provisions of the Act
04	Levies additional income tax at the rate of 15% on domestic companies on the amount declared, distributed or paid as dividend out of current or accumulated profits
05	For the purpose of calculation, tax on dividend is required to be grossed up
06	No deduction of dividend or tax paid against taxable income of the domestic companies
07	Dividend is exempt in the hands of the shareholders - Extensive Litigation revolving around disallowance under Section 14A of the Act

Demerits of Dividend Distribution Tax

Litigation in relation to Section 14A of the Income Tax Act, 1961 (**"Act"**)



Penalizing companies distributing earnings to shareholders vis-à-vis retaining the surplus for investment

Absence of credit in home jurisdictions for non-residents leading to an increase in cost of investment for foreign investors

Regressive mode of taxation

New dividend taxation regime with effect from 01 April 2020

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1. **Effective date**
   Classical taxation system for dividend with effect from 01 April 2020 with abolishment of DDT

2. **Taxability of dividend**
   Dividend taxable in the hands of the recipient in all cases

3. **Withholding**
   Taxes shall be required to be deducted at source on dividend income at the rate of 10% for resident shareholders and at the rate of 20% for non-resident shareholders (subject to treaty benefits)

4. **Deduction for intercorporate dividends**
   The cascading tax effect in case of inter-corporate dividends is eliminated by providing a deduction in respect of dividends received by a domestic company to the extent such dividend is distributed.

5. **Deductibility of interest expenditure**
   Interest expenditure shall be allowed as deduction from dividend income, subject to a cap of 20% of such income

Beneficial taxation regime for dividend received from foreign companies

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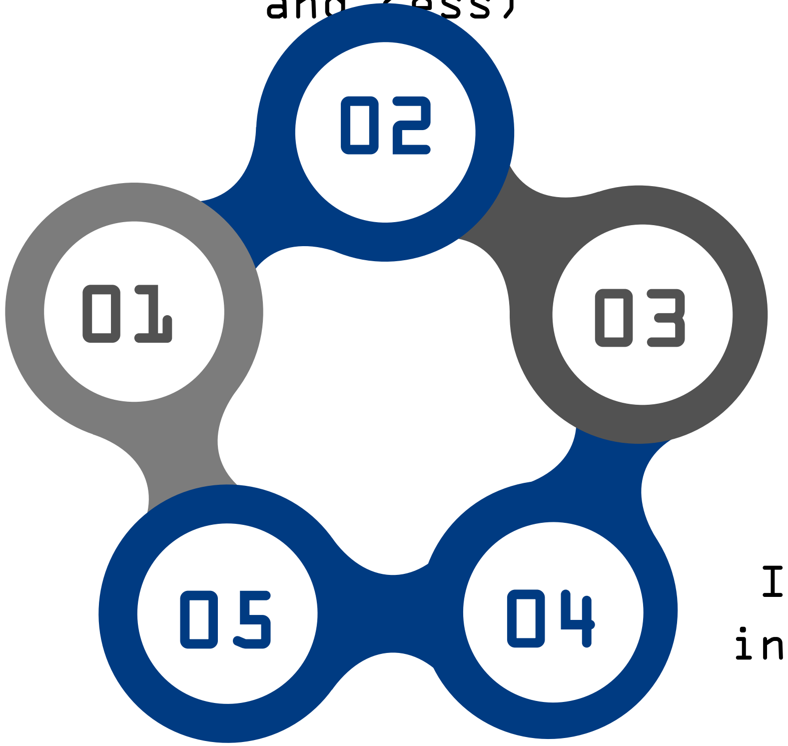
Dividend taxed at the rate of 15% (plus applicable surcharge and cess)

Special taxation rate for dividend income received by Indian companies from "Specified foreign companies" under Section 115BBD of the Act



"Specified foreign companies" include companies where the Indian company holds 26% or more in nominal value of the equity share capital of the company

In computing such dividend income, no deduction for any expenditure (including interest expenditure) or allowance is allowable.

Section 115BBD has been omitted from FY 2022-23 onwards

Credit of DDT for foreign shareholders

- Foreign shareholders are taxable in their home jurisdiction on dividend received from Indian companies

- Dividend was exempt in the hands of shareholders in India (except dividend covered under section 115BBDA of the Act)

- Difficulty faced by foreign shareholders in accessing tax treaty because of the following reasons:
  - DDT is a tax on the company and not the shareholder
  - No case of double taxation for the investors

- Higher incidence of tax on foreign investor and leads to economic double taxation

Dividend taxation - Non-resident's perspective - 1

Beneficial rate under the treaties

- Taxation of dividend under treaties is generally in the range of 10%-25%. However, lower rate of taxation at the rate of 5% exists in treaties with Hong Kong, Malaysia, Mauritius, etc
- Lower rate under treaties available only if the recipient is a "beneficial owner" of Dividend
- Courts have held that a person may not qualify as a beneficial owner if its right to use and enjoy the income is constrained by a contractual and legal obligation to pass on that income to its

Interplay of tax treaties with Multilateral Instrument (MLI)

- MLI is an outcome of BEPS Action Plan 15 of the OECD/G20 Inclusive Framework, which offers solutions for governments to plug loopholes in international tax treaties
- India is a signatory to the MLI due to which treaties entered into by India stand amended by the provisions in MLI
- MLI introduces an additional criteria of "365 days minimum holding period" for the shareholder to avail concessional tax rates under the tax treaty
- India has opted to apply such provision (except in cases where similar provision(s) are contained).
- Hence, this provision shall apply to all the treaties of India except where a reservation is made by the treaty partner
- Further, it is pertinent to note that the treaty benefit can be denied if obtaining benefit under the tax treaty was one of the principal purposes of an arrangement or transaction unless such benefit is in accordance with the object and purpose of the tax treaty (Principal Purpose Test).

Dividend taxation – Non-resident's perspective – 2

Interplay with the Most Favored Nation ("MFN") clause

- An international concept that entitles the eligible tax residents to adopt the beneficial treatment (by way of a lower rate or restricted scope) accorded by the treaty partners to a third country which is a member of OECD.
- MFN clause is present in the treaties with France, Hungary, Netherlands, etc.
- Tax rate of dividends under these treaties stand reduced from the agreed 10% to 5%, importing beneficial taxation rate which India has agreed with other countries such as Slovenia, Colombia, etc.
- The matter of interpretation of the MFN clause has always been a matter of discussion not just domestically but across countries.
- Few areas of potential litigation in India on account of divergence in views of:

a) Taxpayer friendly judicial pronouncements and decrees issued by the treaty partners; and

b) Position taken by the Central Board of Direct Taxes (CBDT) in a circular issued pursuant to the pronouncements is captured in the ensuing slides

Difference in interpretation of MFN clause

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Position adopted by Domestic Courts/Decrees of treaty partners	Position adopted by CBDT
▪ The relevant date for testing OECD membership status for the Third State (Slovenia, Lithuania and Colombia) is the date when the taxpayer intends to avail the benefit ▪ Application of the MFN clause is automatic ▪ Decrees issued by certain treaty partners declared that the rate of tax on dividend income under their respective tax treaties with India shall reduce to 5% by invoking the MFN clause	▪ The Third State should be an OECD member at the time of the conclusion of India's tax treaty with the Third State ▪ A government notification shall be required to import provisions of any third country into the concerned tax treaty by virtue of the MFN clause. ▪ The decree/bulletin/publication issued by other jurisdictions does not represent any mutual understanding between India and the respective jurisdiction and the same have been issued without any bilateral consultation with India ▪ When a beneficial provision under a Third State is borrowed by invoking the MFN clause, the taxpayer has to import such beneficial provision along with the associated conditions and thus, selective import of a provision is not permissible.

SAMPLE MFN CLAUSE IN PROTOCOL

01

*[…], if under any Convention […]signed after 1-9-1989, between India and a third State **<u>which is a member of the OECD</u>**, India limits its taxation at source on dividends, […] to a rate lower […] than the rate […] provided for in this Convention […] the same rate […] as provided for in that Convention[…] on the said items income shall also apply under this Convention, with effect from the date on which the […] relevant Indian Convention, Agreement or Protocol enters into force […]*

02

Issue: Does the subsequent contracting nation have to be an OECD member as on the date when the protocol was signed? Or does the subsequent contracting nation have to be an OECD member as on the date when the tax benefits are sought to be claimed?

Litigation Trajectory

Delhi HC
Indo-France
DTAA
Fees for
Technical

Nestle SA-
Delhi HC
Indo-
Switzerland
DTAA
Dividend

Services: Del
HC
Indo-
Netherlands
DTAA

Epcos Electric:
Del HC
Indo-Spain DTAA
Fees for
Technical
services

Nestle SA
Supreme Court

Matter de
tagged by SC.
Yet to be
listed.

Supreme Court ruling takeaways

- The MFN Clause only contemplates a scenario where the third contracting nation was a member of the OECD as on the date when the Protocol was signed.
- Distinction between 'dualist' and 'monist' countries highlighted. Emphasis laid on how India is a dualist nation.
- Benefits under the MFN Clause would not automatically apply in the absence of an enabling legislation (i.e., statute or notification) in domestic law.
- Interpretation of tax treaties cannot be done in the same manner as statutory interpretation. Due regard must be given to the context of provisions, state practice, and political considerations.

An overview of interest

A return on debt funding

A fixed charge against a Company's revenue

Predictable income of the lender leading to stability

Tax benefit as Interest is a deductible expenditure

Debt-Equity ratio to be delicately balanced based on multiple factors including leverage sought, expansion plans, tax

Scope of taxation of Interest

"Interest" as per section 2(28A) of the Act means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized. Scope of taxation for interest is as under:

ROR taxation

ROR are taxable on interest received from an Indian company as well as from foreign companies

NR and RNOR taxation

NR and RNOR are taxed only on:

a) Interest received in India;

b) Interest on debt utilized for the purpose of earning Indian sourced income

- Interest covers any type of money borrowed as debt. Considering multiple hybrid instruments issued by entities, it is important to identify debt instruments

Taxation for non-residents | Domestic law

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The rate of taxation and the withholding tax rate applicable for non-residents shall be dependent on the currency of borrowing and the nature of debt instrument in which the non-resident has invested.

5%

- Interest from infrastructure debt fund
- Interest on monies borrowed from a source outside India by way of issue of rupee denominated bond
- Interest on monies borrowed in foreign currency from a source outside India, under a loan agreement
- Interest from long-term bond including long-term infrastructure bond
- Interest on monies borrowed from a source outside India by way of issue of any long-term bond or rupee denominated bond listed on a recognized stock exchange in any International Financial Services Centre
- Interest on a rupee denominated bond of an Indian company earned by Foreign Institutional Investor
- Interest from municipal debt securities

20%

- Interest received from Government or an Indian concern on monies borrowed or debt incurred by Government or the Indian concern in foreign currency (not being interest of the nature specifically addressed above)

40%

- Interest attributable to a Permanent Establishment of the non-resident

Taxation for non-residents | Tax treaties

- A lower rate of taxation for interest income possible under the tax treaties between India and multiple foreign countries
- The tax rates under the treaties are an outcome of inter-governmental relations, policy decisions, fiscal measures
- Tax rate under multiple treaties which India has entered into have tax rates ranging from 10% to 15% (with a few treaties outside this general range)
- Lower rate under treaties available only if the recipient is a "beneficial owner" of Interest and other anti-abuse provisions are not triggered
- Further, similar to dividend, the MFN clause shall be applicable also in case of taxation of interest income under the tax treaties
- Tax rates under treaties are an important factor to determine the jurisdiction from where investments are made
- The tax rates under treaties is higher in certain cases of income wherein the domestic tax rates of India are beneficial
- Further, transfer pricing considerations need to be kept in mind while determining the rate of interest applicable for a loan from an "Associated Enterprise" including:
    1. Benchmarking analysis;
    2. Transfer Pricing compliances; and
    3. Comparable analysis

Thin capitalization provisions under the Act

01

Thin capitalization refers to a situation where a Company is financed with a high level of debt as compared to capital leading to a thin capital structure

02

Thin capitalization provisions enshrined under Section 94B of the Act wherein interest or similar consideration for debt issued **by an Associated Enterprise** is allowed as a deduction against taxable income only to the extent of 30% of Earnings before Interest, Tax, Depreciation and Amortization.

03

Provisions applicable only where deduction of interest is claimed over INR 1 crore

04

The amount not allowed as a deduction in a particular year is allowed to be carried forward for a period of 8 assessment years

05

The carried forward amount shall be added to the interest amount of the ensuing year to ascertain the maximum amount allowable as a deduction

06

Provisions not applicable to Indian company or a permanent establishment of a foreign company engaged in the business of banking or insurance

07

Limitation to available deduction has a higher impact for borrowers in their growth phase or in the phase of undertaking capital expansion projects with debt funding

08

Even though there is a limitation to the deduction available to the borrower entity, the entire interest may be taxable in the hands of the Associated Enterprise

Interest | Interplay with tax treaties

Domestic tax law rate range

Tax treaties offer concessional tax rates

Tax treaties can be used as a commercial negotiating tool by governments

Choice of investing jurisdiction

Commercial substance requirement

Benchmarking analysis

Interest | Other aspects

Interest payable by a partnership firm or Limited Liability Partnership (LLP)

- Partnership firms or LLP are allowed to pay interest on loan to partners if it is authorized by and in accordance with the terms of the partnership deed
- Interest paid to partners is allowable as a tax deduction for the partnership firm or LLP to the extent of 12 per cent simple interest per annum
- Interest income received by the partners is taxable under the head "Profits and gains from business of profession"

Interest on Provident Fund contributions

- Interest earned on provident fund has been fully exempt in the hands of the employees
- With effect from 01 April 2021, Interest earned by an employee on the contribution of an employee of over Rs 2.5 lakh is taxed in the hands of the employee
- Tax shall be deducted at source on such interest income

Interest on delayed payments

- Interest received on delayed payments on contractual payments are taxable

Conclusion

01 Income tax implications of dividend and interest to be considered before determining the mode of funding of an entity

02 Dividend payment does not provide a tax break to the payer entity

03 Interest shall be an allowable expenditure (subject to a limits under the thin capitalization rules)

04 Impact of the paradigm shift in the dividend taxation regime

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