Workshop on taxation of Foreign Remittances

DIVIDENDS and INTEREST

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Dividends

- Tax withholding will arise if dividends being remitted are taxable.
- Under India's domestic law dividends are exempt u/s 10(33).
- As such, reference to treaty will not arise in most cases.
- Treaty models discussed for academic point of view.

ARTICLE 10 DIVIDENDS - OVERVIEW

* UN Model	* OECD Model
1 Taxable in the State of Residence. May also be taxed in the State of Source.	1 Same as UN Model
2 If the recipient is the "beneficial owner" then reduced rate of tax.	2 Similar to of UN Model except that OCED Model provides specific reduced rate of taxes. UN Model has left percentage to bilateral negotiations.
3 Definition of the term "Dividends".	3 Same as UN Model
4 Dividend effectively connected to P.E/ Fixed Base of the beneficial owner	4 Same as UN Model
5 Prohibition of extra - territorial taxation of dividends.	5 Same as UN Model

TAXABILITY

Article 10 (1 and 2)

- State of Residence of the recipient has primary right to tax under both Models.
- Taxable also in the State of Source.
- Concessional rates are applicable if the recipient is the “Beneficial owner” (B.O.)

Article 10 (2)

Concept of beneficial owner

Relevant for :

Article 10 -	Dividends
Article 11 -	Interest
Article 12 -	Royalties

BENEFICIAL OWNER

•Beneficial owner has not been defined in the Model Conventions as well as in the bilateral treaties with most of the countries. OECD Model convention states that the term “beneficial owner” is not used in narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation.

•It is an anti-tax avoidance provision, which is incorporated with the objective of avoiding treaty shopping.

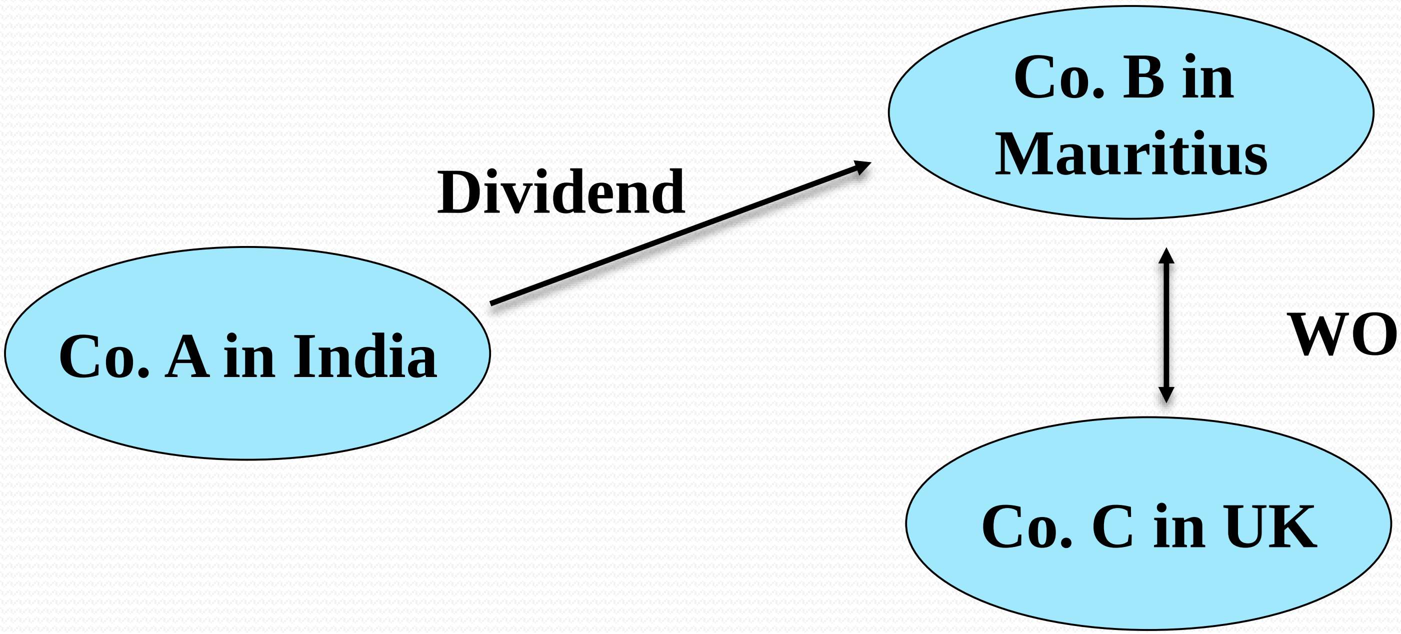
•No minimum period of holding is prescribed.

•Prevost Car inc (2008 TCC 231): The person who is beneficial owner of the dividend is the person who enjoys and assumes all the attributes of ownership.

•Natwest ruling (220 ITR 377):

TAXABILITY

Article 10 (1 and 2)



India - Mauritius Treaty will apply only if Co. B is the Beneficial Owner of the investment in shares of Co. A

ARTICLE 10 – DIVIDENDS

DATE WHEN 'PAID'

- Not settled by OECD / UN
- Broad Interpretation - Shareholder claim to receive
- Dependent on Agreement between countries
- Putting funds available to shareholder
- Declaration of Dividend - Generally

TAXABILITY

Article 10 (2)

- UN Model

  Concessional rates by bilateral negotiations

  Further concession if the beneficial owner being a company holds directly 10 % capital of the payer company

- OCED Model

  5 % if the B.O. is company holds 25 % capital of the payer company (15% in all other cases.)

- The article limits source taxation on dividends only and expressly states that it does not affect taxation of the Company in respect of the profits out of which the dividends are paid.

Art 10 NA if dividends arise in another country.

DEFINITION

Dividend means income from

- Shares
- Jouissance shares or rights,
- Mining shares
- Founders’ shares or
- Other rights not being debt claims
- Participating in profits
- Other Corporate rights which is treated as “dividends” in the state of source [i.e. income from which not deductible in computing income of the corporate]

AAR in OTIS CASE

<u>AAR in OTIS case re-characterized Buy Back of shares as dividends on account of:</u>

•The Indian company did not declare dividends since the year of introduction of DDT even though it had significant reserves

•There was selective buy-back of shares (only Mauritius shareholder "opted" for buyback)

•Profits were proposed to be repatriated through buy-back of shares to mitigate tax incidence in India

•The proposed transaction was a colourable device
•Exemption u/s 10(33) not available as DDT not paid

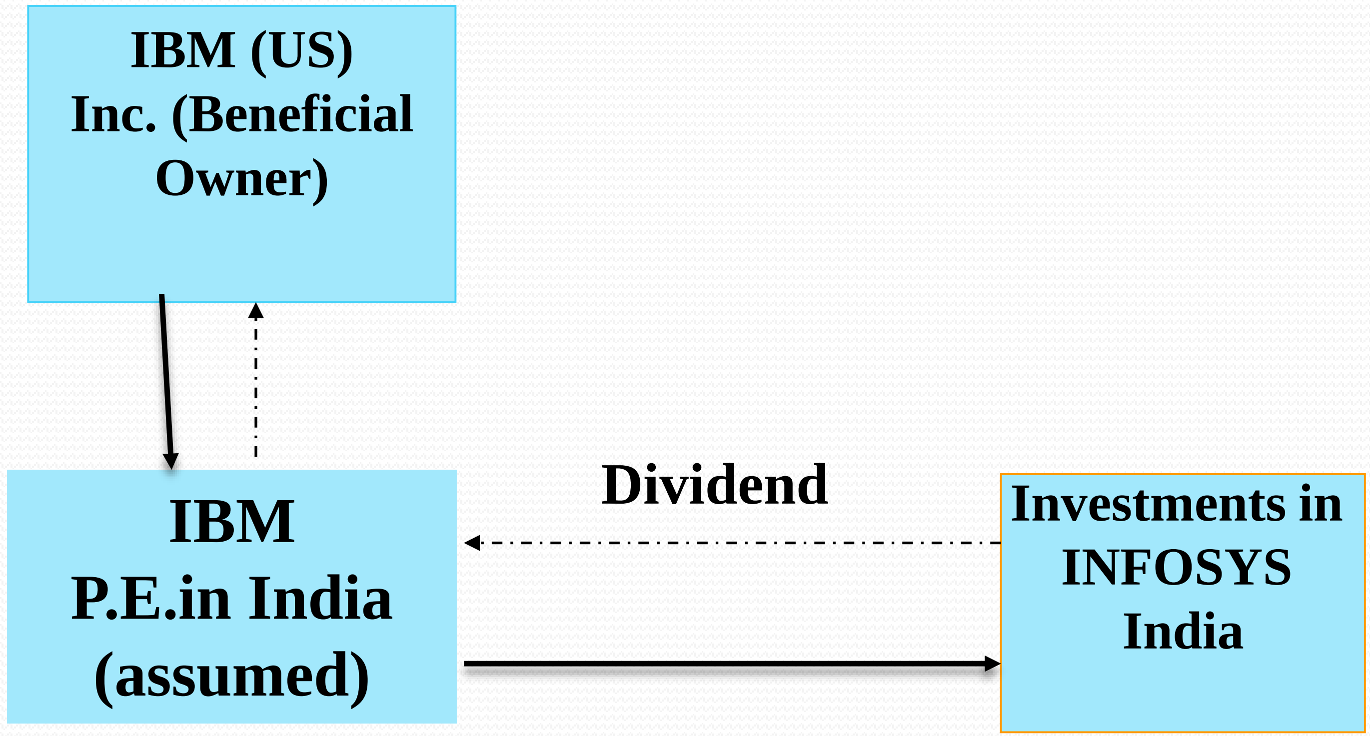
Now BBT introduced

DIVIDENDS TAXABLE AS BUSINESS PROFITS

<u>Article 10 (4) provides that :</u>

- Limits on taxation in Source Country will not apply where share holding is effectively connected to a P.E. or fixed base. In such a case, distribution would be taxed as Business Profits or Independent Person Services.

Article 10 (4) - DIVIDEND EFFECTIVELY CONNECTED TO PE IN SOURCE COUNTRY



TAXABLE AS BUSINESS PROFITS (Article 7) or Income from independent personal services (Article 14) – On net basis at rate applicable to business income [not concessional rate]

PROHIBITION OF EXTRA TERRITORIAL TAXATION OF DIVIDENDS

Article 10(5)

Article prevents one country (SAY:UK) from taxing dividends paid by a company resident in the other country (India) merely because the profits or income underlying the dividends arose in the first country (UK). It can be taxed only if the recipient is the resident of the first country (UK) or dividend is effectively connected with P.E. It also prevents imposition of tax on the undistributed profits of a company which is a resident of the other country (India).

OTHER ASPECTS

- As both countries have taxing rights, the tax paid in Source Country is allowed as a credit against tax payable in Residence country – Art. 22 – Underlying tax credit also allowed in some DTC; e.g. Australia, Germany, Mauritius. Tax sparing credit also allowed in some cases, e.g. Mauritius

- If dividends are not taxable under domestic law or due to other reasons, e.g. Parent Subsidiary Directive, not to be levied, DTC will not impose tax.

DIVIDEND SOME FAQS

1. **Whether deemed dividend u/s 2(22)(e) is to be treated as Dividend for the purpose of DTAA?**

2. **Whether dividend distribution tax is eligible for tax credit to person resident of the other contracting state?**

Foreign Tax Credit – Example FDI

Credit in Ordinary Manner

- M Co earns Dividends from I Co – US$ 100,000
- TDS from India = NIL
- Actual Tax paid in India = $ 15,000 (DDT – Credit available)
- Tax in Mauritius @ 15% = $ 17,250 (15% of 100,000 + 15,000)
- Net Tax to be paid in Mauritius= $ 2,250 – Vs. Net tax of $ 3,000 without claiming credit

Deemed credit

- M Co earns Dividends from I Co – US$ 100,000
- TDS from India = NIL
- Actual Tax paid in India = $ 15,000 (DDT)
- Tax in Mauritius @ 15% = $ 17,250 (15% of 100,000 + 15,000)
- Deemed Credit @ 80% of $ 17,250 = $ 13,800
- Net Tax to be paid in Mauritius= $ 3,450 Vs. Net tax of $ 3,000 without claiming credit

Foreign Tax Credit – Example ODI

- I Co gets dividend of US$ 1,00,000 from M Co
- Tax payable in India u/s ___ @ 15%
- WHT on dividends in Mauritius NIL
- Underlying tax paid in Mauritius 15% / 3%
- If tax "paid" in Mauritius is considered as 15%, no further tax to be paid in India !
- Whether 12% deemed credit in Mauritius is tax spared in Mauritius? If so, even then no further tax to be paid in India, due to tax sparing clause

Interest

- Section 9(1)(v) of Income Tax Act, 1961
  - Income by way of Interest payable by
    - The Government; or
    - A person who is a resident, except where the interest is payable in respect of any debt incurred or money borrowed and used, for the purpose of a business or profession carried on by such person outside India or for the purpose of making or earning any income from any source outside India or
    - A who is a non-resident, where the interest is payable in respect of any debt incurred, or money borrowed and used, for the purpose of a business or profession carried on by such person in India

Definition of Interest – Section 2

- (*28A*) "interest" 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 utilised ;]
- (*28B*) "interest on securities" means,—

(*i*) interest on any security of the Central Government or a State Government ;

(*ii*) interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act ;]

TDS rates under Finance Act, 2013

Type of borrowing – in	Covered by item of Part II of Finance Act, 2013	If Interest is upto Rs 1 crore	If Interest is between 1 crore and 10 crores	Interest above 10 crores
Foreign Currency	2(b)(iii)	20%	21.012%	21.63%
Other than Foreign Currency	2(b)(x)	40%	42.024%	43.26%

TDS Rates under ITA – Contd.

- Section 194LB deals with interest payable by an infrastructure debt fund and section 194LC deals with interest payable by an Indian Company on monies borrowed under a loan agreement approved by the Central Government in this regard. The applicable rate in such cases is 5%
- Section 194LD also provides for a 5% rate of Interest on rupee denominated bonds of an Indian company

ARTICLE 11 - INTEREST ARTICLE OVERVIEW

UN / OECD

1. Primary right to tax with State of Residence
2. Right of S to tax subject to ceiling limit..
3. Definition of the term “interest”
4. Interest to be taxed as business profits if arise through P.E. / fixed base.
5. Circumstances wherein Interest deemed to arise in S of S or in state where P.E./ Fixed base is situated..
6. Tax treatment of “Excess Interest” having regard to special relationship between payer and the beneficial owner.

TAXABILITY- Under treaties

Article 11 (1)

Primary right with State of Residence however, Taxable at reduced rate in the State of Source if the recipient is the beneficial owner .

Examples of rate in state of source

Indo-USA	- 10% if interest paid to a bank 15% in other cases
Indo - Malta	- 10%
Indo - Cyprus	- 10%
Indo - Mauritius	- as per domestic laws (42% in case of India if the recipient is foreign Company having PE in India)/ Exempt for Banks

TAXABILITY

Article 11 (2)

In many treaties interest income is exempt in the state

of source if it is derived and beneficially owned by

a) the Government or a local authority of the other contracting state

b) any agency or entity created or organised by the Government of the other contracting state

Example : UK

c) a bank

Example : Mauritius

DEFINITION

Article 11 (3)

Exhaustive definition to include

- Income from debt - claims of every kind – even if entitled to participation in profits of borrower.
- Income from Government Securities / Bonds / Debentures

Interest excludes

- Discount
- Penalty charges for late payment
- Consideration for debt securitisation

•Income from debt if also entitled to share in liquidation of borrower (Treat as dividends)

INTEREST TAXABLE AS BUSINESS PROFITS

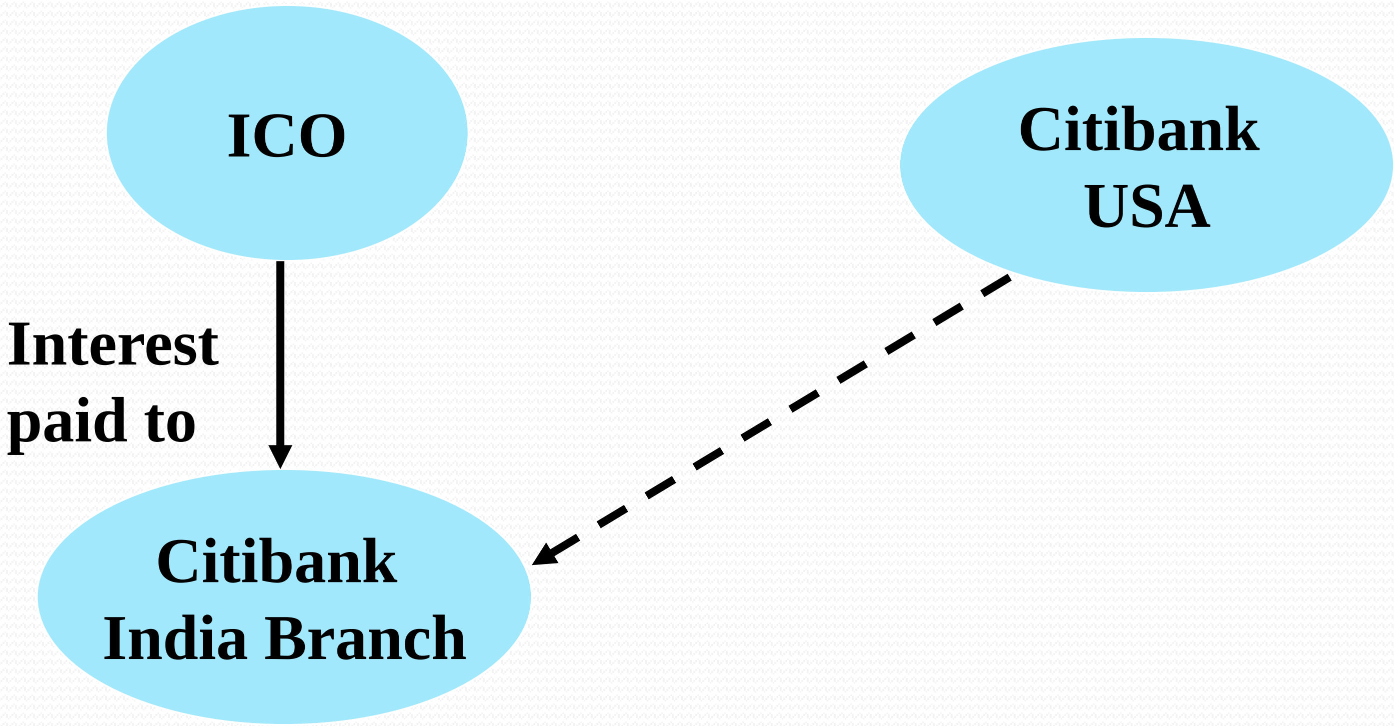
Article 11 (4)

If payment of interest is effectively connected with a permanent establishment or a fixed base such income is taxable as the business profits or as income from independent personal services in the hands of the beneficial owner .

UN Model – provides for Limited Force of Attraction for direct loans if there is a PE

INTEREST TAXABLE AS BUSINESS PROFITS

Article 11 (4) – Interest effectively connected with a P.E.



Interest taxable as Business Profits in the hands of the Citibank USA

SITUATION DETERMINING STATE OF SOURCE

Article 11 (5)

Interest is deemed to arise in the state when the payer is

i. the state itself ,
ii. a political sub-division,
iii. a local authority or
iv. any resident of the state of source

Art 11 NA if interest arises in another country.

Payment of interest is in connection with a P.E. or fixed base and such interest is borne by such P.E. or fixed base .

ASSOCIATED ENTERPRISES

Article 11 (6)

SPECIAL RELATIONSHIP BETWEEN PAYER AND THE BENEFICIAL OWNER OR BETWEEN BOTH OF THEM AND SOME OTHER PERSON

- Excess interest owing to special relationship
- Taxable according to local laws after applying other treaty provisions

CONFLICT WITH THIN CAP RULES

- If debt treated as equity due to Thin Cap Rules, then interest payment to be requalified as dividends for taxation in source country.
- But while applying DTC, definition of interest / dividends under DTC to be respected, and may need considering it as interest, not dividends (Czech – NL case of 2005) – unless treaty has been overridden.

OTHER ASPECTS

- As both countries have taxing rights, the tax paid in Source Country is allowed as a credit against tax payable in Residence country – Art. 23
- If interest is not taxable under domestic law or due to other reasons, e.g. Interest on NRE a/c, or Interest – Royalty Directive.
- DTC will not impose tax.

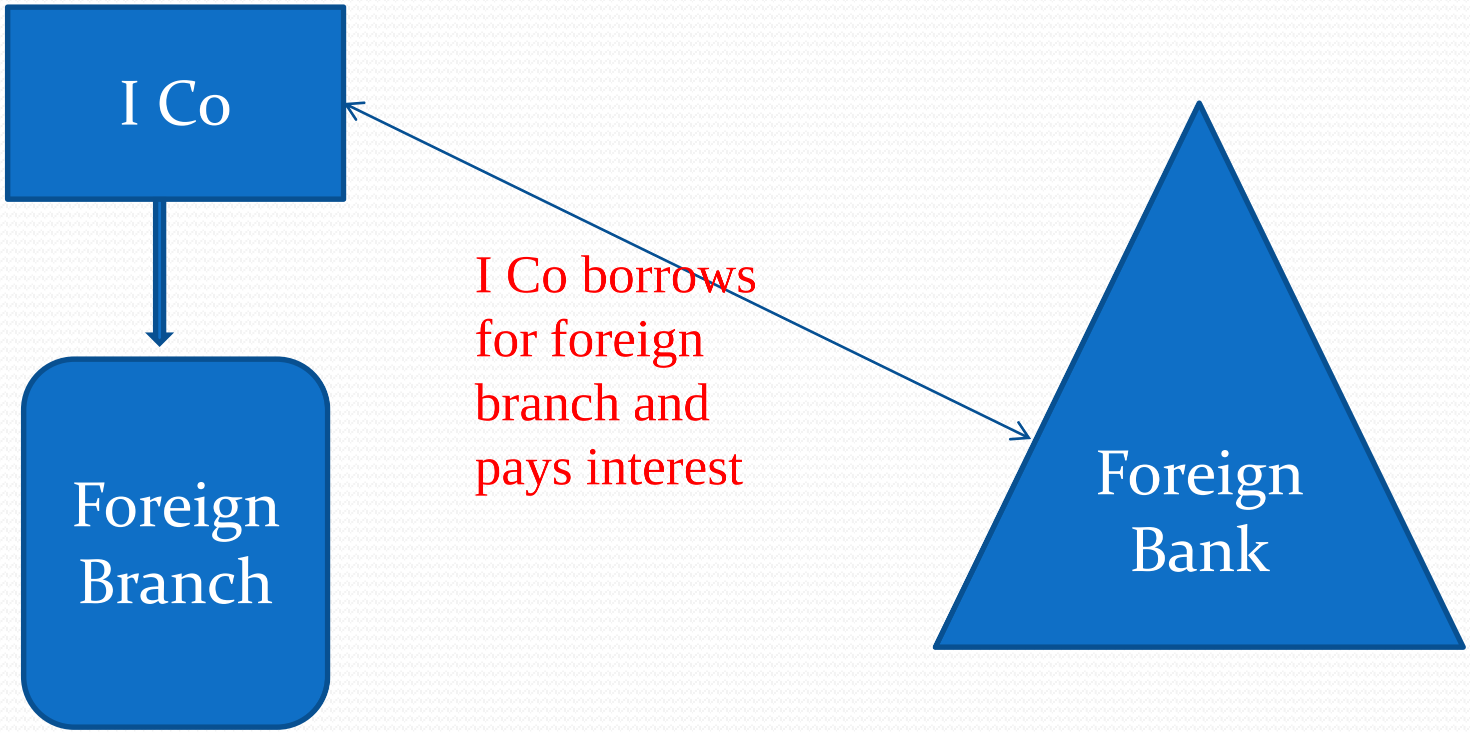
TDS on interest on income tax refund received by non-residents

- Any payment to non-residents (including interest on tax refunds) is liable to be covered under TDS if the same is chargeable to tax in India.
- The above view is also confirmed by Mumbai Tribunal, which has held that interest paid under section 244(1A) of ITA is interest on a debt claim and is thus covered in the definition of "interest" in the India–UK Treaty. The Tribunal while delivering its decision, relied on AAR judgment in *ABC, in P-17 of 1998, In re* [1999] 236 ITR 637, wherein the AAR had taken a similar view.

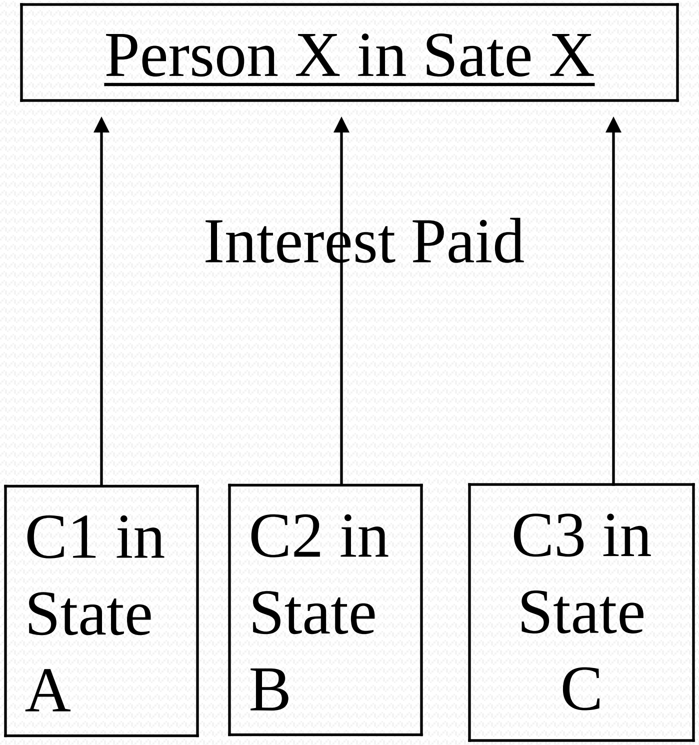
Interest under Court Decree

- Bombay High Court has held that when interest becomes part of a judgment debt, it loses its character of interest and tax is not deductible on interest component payable under a decree - [Refer to *Islamic Investment Co. v Union of India* [2004] 265 ITR 254 (Bom)].

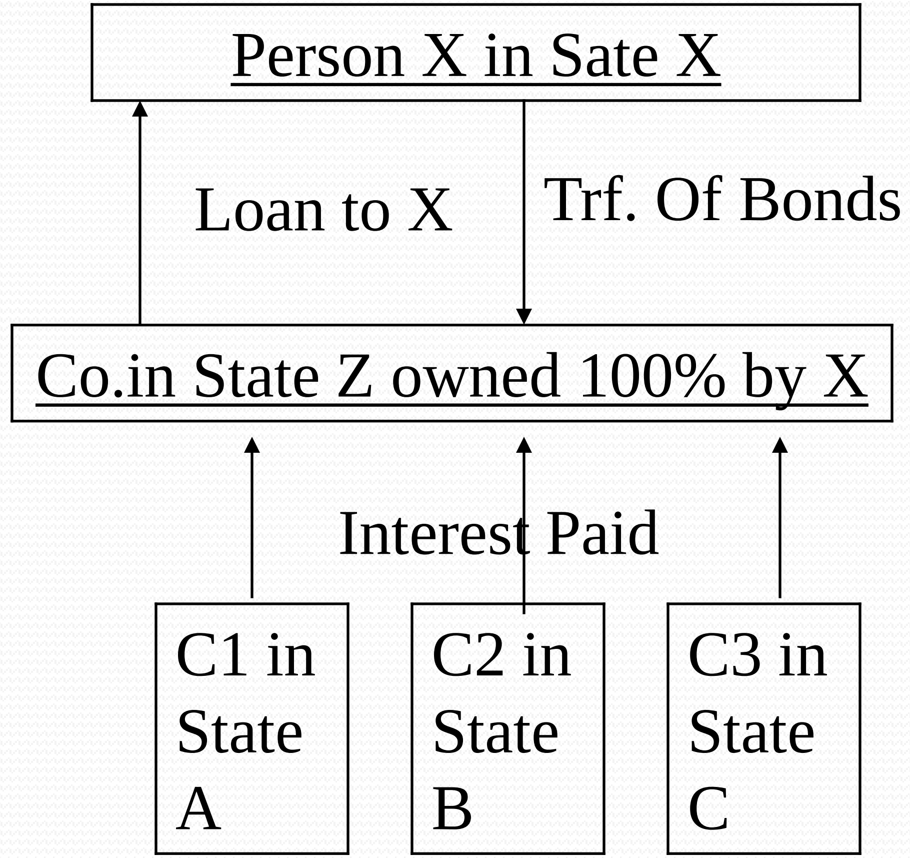
Interest on loan taken by Foreign branch



TREATY SHOPPING # 1

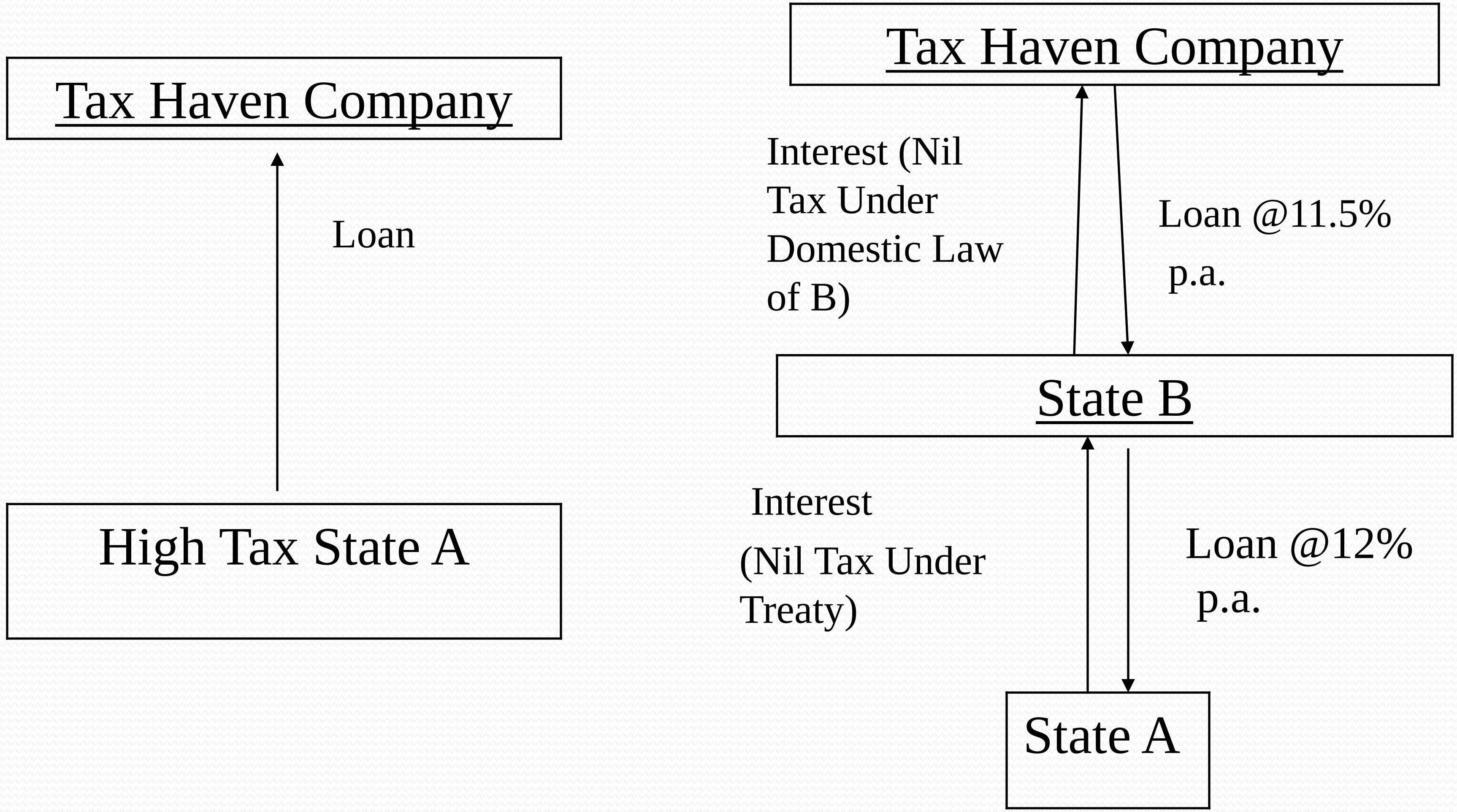


Tax payable in A, B & C, as No treaty between A-X, B-X, C-X



1. Treaties exist between Z-C1, Z-C2 & Z-C3.
2. Low tax in State Z

Treaty Shopping # 2



Interest on ECB

Bank – HO Canada

ECB from HK Branch

Mumbai Branch involved in documentation

Borrower in India

Receives service charges from HK

India Canada DTC - FOA

The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the ***interest arises, through a permanent establishment situated therein****, or performs in that other State independent personal services from a fixed base situated therein,* ***and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment*** *or fixed base. In such case, the provisions of Article 7 or Article 14, as the case may be, shall apply.*

WHETHER INTEREST?

- Interest on Unpaid Purchase Price
  - Vishakhapatnam Port Trust (144 ITR 146) AP
  - Vijay Ship Breaking Corpn. (261 ITR 113) Guj
- Guarantee fees
- Commitment charges
- Discounting Charges
- Appraisal Fees
- Interest payable as per arbitration award

* THANK YOU *