Whether DDT is eligible for a beneficial DTAA rate?

The Special Bench of the Income Tax Appellate Tribunal ('Tribunal') has recently pronounced a landmark decision on the issue as to whether the Dividend Distribution Tax ('DDT') imposed under Section 115-O of the Income-tax Act, 1961 ('Act') ought to be restricted to the dividend withholding tax rate stipulated in the applicable Double Taxation Avoidance Agreement ('DTAA'). The Tribunal has held that DDT is an additional tax levied on the company and not on the shareholder and accordingly, the benefit of lower tax rate as per the relevant DTAA for taxation of dividend will not be available in case of non-resident shareholders, except where specifically agreed upon.

The issue involves very high stakes for the taxpayers as well as the Indian tax authorities. The Special Bench's decision is likely to fuel even more intense litigation.

❖ ***Facts before the Tribunal***

- The taxpayer, an Indian company, declared/ paid dividend during the previous year (AY 2016-17) and one of the shareholders, to whom dividend was paid, was a non-resident (tax resident of France).
- The provisions of Section 115-O of the Act applicable for the year under consideration provided that the taxpayer was required to pay additional income-tax (DDT) on the amount of dividend declared, distributed, or paid by way of dividend.
- Given that the rate of tax on dividend income prescribed in the DTAA is less than the rate prescribed in Section 115-O of the Act, the taxpayer raised a plea before the Tribunal that the rate of DDT in terms of Section 115-O of the Act cannot be more than the rate at which dividend can be taxed in the hands of the non-resident shareholder in terms of the DTAA between India and France.
- In support of the above plea, the taxpayer took support from the following decisions:
  - Delhi Tribunal in the case of *Giesecke & Devrient India Pvt. Ltd. v. ACIT [2020] 120 taxmann.com 338*;
  - Kolkata Tribunal in the case of *DCIT v. Indian Oil Petronas Pvt. Ltd. [2021] 189 ITD 490*.
- While dealing with the case of the taxpayer, the Mumbai Bench of the Tribunal doubted the correctness of the afore-mentioned decisions. The reasons for doubting the correctness were as follows:
  - Hon'ble Supreme Court in the case of *Godrej & Boyce Mfg. Co. Ltd. v. DCIT [2017] 394 ITR 449* has observed that payment of DDT under Section 115-O of the Act does not discharge the tax liability of the shareholders and thus, DDT is not a tax paid by or on behalf of the shareholder. The Mumbai Bench observed that the Delhi Tribunal did not have any occasion to deal with this judicial precedent from the Hon'ble Supreme Court.
  - The Mumbai Bench was of the view that the inference drawn by the taxpayer based on the decision of the Hon'ble Supreme Court in the case of *Union of India v. Tata Tea Co. Ltd. [2017] 398 ITR 260* is misplaced, as the said decision deals with the constitutional validity of the provisions of Section 115-O of the Act and does not overrule, or even remotely deal with the instant issue.
  - No tax credits are envisaged in the hands of the shareholders in respect of DDT paid by the Company in which shares are held. The DDT, thus, cannot be equated with a tax paid by or on behalf of a shareholder in receipt of such dividend.
  - Wherever the contracting states to a DTAA intended to extend the treaty protection to DDT, it has been so specifically provided in the DTAA itself, such as in DTAA between India and Hungary.

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❖ *Question before Special Bench of Tribunal*

In the above backdrop, a Special Bench was constituted by the Hon'ble President for considering the below question:

"*Where dividend is declared, distributed or paid by a domestic company to a non-resident shareholder(s), which attracts additional income-tax (tax on distributed profits) referred to in section 115-O of the Income-Tax Act,1961 (in short 'the Act'), whether such additional income-tax payable by the domestic company shall be at the rate mentioned in Section 115-O of the Act or the rate of tax applicable to the non-resident shareholder(s) with reference to such dividend income.*"

❖ *Submissions on behalf of Taxpayer*

The various contentions of the taxpayers in support of their arguments were as under:

- DDT is a tax on the income earned by shareholders from the company and not a tax on the company. The provisions of Section 115-O of the Act were introduced to mitigate the cumbersome procedure for tax collection on dividend from shareholders, which involved a lot of paperwork. Reliance in this regard was placed on Circular No. 763 dated 18 February 1998.
- The regime of DDT on dividend declared by Indian companies has now been done away with vide Finance Act 2020 with effect from 1 April 2020 and henceforth, amount distributed by way of dividend to shareholders is not subjected to DDT under Section 115-O of the Act but is taxable in the hands of the resident shareholders at the applicable rates.
- The term tax as defined under Section 2(43) of the Act also covers additional income-tax levied under Section 115-O(2) of the Act. Perusal of Section 4(1) of the Act shows that the said section provides for charging of tax including additional income-tax on the total income.
- Section 115-O(2) of the Act specifies that DDT is payable, notwithstanding that no income-tax is payable by the domestic company on the total income. Meaning thereby, the tax paid on dividend declared has no connection whatsoever with the primary income-tax liability in respect of profits of the company declaring/ paying the dividend.
- A combined reading of Section(s) 115-O, 10(34) and 57(i) of the Act makes it evident that legislature itself unequivocally construed the levy of tax under Section 115-O of the Act as a charge on income by way of dividend declared, distributed, and paid by the company.
- When two countries have agreed upon a DTAA for the taxation of the dividend income in the source state at a lower rate, in such a case the charge of a higher rate of tax by introducing a separate mechanism for collecting tax on such dividend income (i.e., DDT in the instant case) is contrary to the principle of treaty override as enshrined in Article(s) 26 and 27 of the Vienna Convention. Reference in this regard was made to the recent decision of Hon'ble Supreme Court in the case of *Engineering Analysis Centre of Excellence Pvt. Ltd. v. CIT (432 ITR 471)*].
- Separate and distinct enactment of Section 115-O(3) of the Act makes it clear that DDT is the liability of the company but on the dividend income of the shareholders. If levy under Section 115-O of the Act is an additional tax on distributed profits of the company, the company would have been liable to pay such tax by virtue of mandate under Section 191 of the Act and no separate provision was required to be made to make the company liable to pay the tax vide Section 115-O(3) of the Act.
- Referring to the DTAA between India and Hungary, it was contended that the complete protection provided to the non-resident shareholders from provisions of the Act should also be extended to the domestic company paying dividend to non-resident shareholders of other countries as well.

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❖ ***Submissions on behalf of Department***

The Department's Representative made exhaustive arguments interpreting the provisions of Section 115-O of the Act under the domestic law and its application and understanding in the context of the provisions of the international tax laws, which are summarized hereunder:

- Section 115-O of the Act shows that it overrides the charging provisions of Section 4 of the Act. Section 115-O of the Act is a separate charging section and hence, it takes no support from Section 4 of the Act.
- The charge under Section 115-O of the Act is on distributable profits of the company and not on dividend. Section 115-O of the Act is not a procedural section but a charging section and deals with undistributed profits and not accumulated profits.
- Placing reliance on the decision of Bombay High Court in the case of *Small Industries Development Bank of India (SIDBI) v. CBDT [2021] 133 taxmann.com 158*, it was contended that the High Court has categorically held that charge under Section 115-O(1) of the Act is on the company's profits, more specifically on that part of the profits which is declared, distributed, or paid by way of dividend. Thus, the charge under Section 115-O(1) of the Act is not on income by way of dividend in the shareholders' hands.
- Relying on the decision of the Supreme Court in the case of *Mathuram Agrawal v. State of Madhya Pradesh [1999] 8 SSC 667*, it was argued that in the context of Section 115-O of the Act, the three essential elements of taxation are as under:
  - the subject of tax: amount declared, distributed or paid by company by way of dividends;
  - who is liable to pay tax: domestic company declaring, distributing or paying an amount by way of dividends;
  - the rate of tax: specified in Section 115-O(1) of the Act.
- Once the tax is levied on a particular specie of profits of the company, then, no scope is left for an argument that the tax so levied is in fact paid by the company either on behalf of the shareholders or has in fact being paid on the dividend income of shareholders. Thus, it was contended that the split between the economic incident on shareholders and statutory levy on companies as made out in the decision in the case of Giesecke & Devrient India Pvt. Ltd. (*supra*) and Indian Oil Petronas Pvt. Ltd. (*supra*) is unknown to tax jurisprudence, both in domestic law as well as in the international law.
- The tax levied under Section 115-O of the Act, both in law and in time, precedes the actual accrual as it gets crystallized at an earlier stage of declaration of dividends. The tax liability under Section 115-O of the Act crystallizes as soon as the dividend is declared.
- It was pointed out that from the shareholder's point of view, the dividend becomes a debt due only when it is distributed and the individual shareholder account is credited with the amount due to them. It is at this stage that the income for non-resident shareholders gets accrued in terms of Section 9(1)(iv) of the Act. From the point of view of tax treaty, definition of dividend in DTAA also used the word "paid".
- The concept of administrative convenience is beyond the scope of statutory interpretation, especially when the language used in the statute is clear and unambiguous. Thus, the concept of mere administrative convenience for shifting the incidents on payer company for collection of tax under Section 115-O of the Act is wrong.
- With reference to application of DTAA, it was submitted that tax under Section 115-O of the Act is a tax on the company and not on the shareholder. Hence, its levy does not give rise to any double taxation.

❖ ***Counter-arguments on behalf of Taxpayer***

Rebutting the submissions of the Department, the submissions made on behalf of the taxpayer were as under:

- The provisions of Section 115-O of the Act cannot be seen in an isolation. In case Section 115-O of the Act was to stand on its own without reference to its genesis in Section 4, then the levy of tax under the former section would not be constitutionally valid.
- It was asserted that the decision rendered by the Bombay High Court in the case of Small Industries Development Bank of India (*supra*) is distinguishable on facts and hence, reliance on the said case is misplaced. In the said case, the High Court took note of the non-obstante clause in Section 50 of the SIDBI Act, which has an overriding effect over the provisions of the Act and held that SIDBI is exempted from paying DDT on dividends under Section 115-O of the Act, and thus, was not liable to pay DDT on dividends and is outside the purview of Section 115-O of the Act.
- In the context of DTAA, it was submitted that the word "paid" is not defined under the provisions of the DTAA, hence, the definition of "paid" as provided in Section 43(2) of the Act must be adopted. Thus, it is incorrect to say that the liability for DDT is discharged prior to accrual of income in the hands of the shareholders. The accrual in the hands of the shareholders is simultaneous with the declaration of dividend and in view of the above, there is no mismatch.

❖ ***Observations and decision of the Special Bench of Tribunal***

The Tribunal examined the various aspects of the arguments raised on behalf of the taxpayer and by the Department and held the following:

- *Meaning of the word "Dividend"*
  - Dividend means the portion of the profit received by the shareholders from the company's net profit, which is legally available for distribution among the members. Therefore, dividend is a return on the share capital subscribed for and paid to its shareholders by a company.
  - If one says dividend is share of profits declared as distributable among the shareholders, it does not mean that the character of the profits distributed by the company as dividend retains the same character when it reaches the hands of the shareholders.

- *Modes of taxing dividend income*
  - Modes of taxing dividend income are (i) classical/ progressive system; (ii) Simplistic system.
  - Under the Act, upto the year 1997, the classical system of taxing dividend income prevailed, wherein the dividend was taxed in the hands of the recipients at rates applicable to them.
  - The Government introduced simplistic system by introduction of Chapter XII-D to the Act [comprising of Section(s) 115-O, 115-P and 115Q] vide the Finance Act, 1997. Simplistic system means a system by which the company which distributes the dividend is required to discharge the tax liability on the sum distributed by way of dividend as an additional income tax on the company itself and consequently, such dividend income was exempt in the hands of shareholders under Section 10(34) of the Act.

- *Section 115-O of the Act*
  - A plain reading of the provisions of Section 115-O of the Act shows that it creates a charge to additional income-tax on any amount declared, distributed or paid by domestic company by way of dividend for any assessment year. The additional income-tax is referred to as "*tax on distributed profits*", commonly referred to as DDT and is a tax on "distributed profits" and not a tax on "dividend distributed".
  - DDT has been abolished by the Finance Act, 2020 and the Government reverted to the classical system of taxation of dividend.

- *Taxation of dividends*
  - Section 5 of the Act provides that residents are taxed on their worldwide income and non-residents are taxed on India-sourced income (i.e., income received or deemed to be received in India and income accrued or deemed to have accrued in India).
  - Section 9 of the Act provides for source-based taxation on the basis of characterization of income. For example, dividend paid by an Indian company is always treated as having source in India.
  - Income or profits which result from international activities such as cross-border investment may be taxed where the income is earned (i.e., in the source country) or where the person who receives it is normally based (i.e., the country of residence).
  - To prevent double taxation, countries enter into bilateral double taxation avoidance treaties. Section 90(2) of the Act specifically provides that where the Government has entered into a DTAA with the Government of any country outside India for granting relief of tax, or as the case may be, for avoidance of double taxation, then in relation to the assessee to whom such DTAA applies, the provisions of the Act shall apply to the extent they are more beneficial to that assessee.
  - If DTAA between India and another country, say country X provides for taxation of dividend income based on Article 10 of Organization for Economic Cooperation and Development ('OECD') model, then that would mean that dividend paid by an Indian company to a shareholder who is resident of Country X, may be taxed in Country X.
  - Simultaneously, Article 10 permits that 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. This would mean that dividend paid by an Indian company may be taxed in India based on source rule and again taxed in country X based on residence rule. In such a scenario Article 10 of the OECD stipulates a limit upon the rate of tax in the source state by restricting the rate of tax to a specified percentage of tax. In most Indian DTAAs, this limit is of 10% and by implication it means that the levy of tax by India on dividend paid by Indian companies to shareholders resident in those DTAA countries cannot exceed 10%.

- *DDT: whether tax on the company or the shareholder*
  - The Supreme Court while dealing with the constitutional validity of Section 115-O of the Act in the case of Tata Tea Co. Ltd. (*supra*), has held that under Section 2(24)(ii) of the Act dividend is included in 'income' and is thus covered by Entry 82 of List I to Seventh Schedule, "taxes on income, other than agricultural income".
  - The argument that DDT is paid on behalf of the shareholder and must be regarded as payment of liability of the shareholder, discharged by the domestic company paying DDT, is neither correct nor does it flow from the ratio laid down in the decision by the Supreme Court in the case of Godrej & Boyce Mfg. Co. Ltd. (*supra*).
  - It is clear from the decision of the Bombay High Court in the case of Small Industries Development Bank of India (*supra*) that charge under Section 115-O of the Act is on the company's profits and not on income in the hands of the shareholder.
  - The provisions of TDS and TCS specifically provide that tax deducted at source and tax collected at source are payments on behalf of the payee i.e., the person liable to pay income-tax on the sum paid. It provides for discharge for the payer on payment to the credit of Government of the amounts due to the payee. In the event the payer pays excess over and above what he must pay the payee, he gets a right to recover the TDS or TCS and gets rights of subrogation. Such provisions are absent in the entire scheme of Chapter XII-D of the Act. These features are again an indication that DDT is a charge to tax on the profits of the company and not a charge in the hands of the shareholder or tax paid on behalf of the shareholder by the domestic company.

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- *Applicability of DTAA*
  - A reading of Article 10 of the model OECD DTAA shows that dividends paid by a company which is a resident of a Contracting State (say India) to a resident of the other Contracting State (say France) may be taxed in that other State (France). However, if the beneficial owner of the dividend is a resident in France, the tax so charged shall not exceed specified percent. The first condition is that the non-resident in France should be taxed in India. We must look at the DTAA from the recipient's taxability perspective. DDT is paid by the domestic company resident in India. It is a tax on the domestic company's income and not tax paid on behalf of the shareholder. In such circumstances, the domestic company paying DDT under Section 115-O of the Act does not enter the domain of DTAA at all.
  - If domestic company has to enter the domain of DTAA, the countries should have agreed specifically in the DTAA to that effect. In the treaty between India and Hungary, the Contracting States have extended the treaty protection to profits distributed by the Indian company by deeming the DDT paid by the Indian company as tax paid by shareholder and restricting the DDT rate to 10%. In the absence of similar deeming provision under other DTAAs, treaty benefit cannot be granted to the Indian company paying the DDT in such other DTAAs.

- Basis the reasoning given above, **it has been concluded that where dividend is declared, distributed or paid by a domestic company to a non-resident shareholder, which attracts DDT referred to in Section 115-O of the Act, such DDT payable by the domestic company shall be at the rate mentioned in Section 115-O of the Act and not at the rate of tax applicable to the non-resident shareholder as specified in the relevant DTAA with reference to such dividend income**. Wherever the Contracting States to a tax treaty intend to extend the treaty protection to the domestic company paying DDT, only then, the domestic company can claim benefit of the DTAA, if any.

Author's views

This is a major ruling, wherein the Special Bench of the Tribunal has put to rest the continuing controversy on the issue of DDT. The Tribunal, in the present case, has highlighted that DDT is an additional income-tax on the company's profits and not on the income in the hands of the shareholder. Hence, the lower rate of tax on dividends as per the DTAA applicable to the shareholder will not apply to DDT on distributed profits (unless specifically provided for in the DTAA as in the case of India-Hungary DTAA).

The domestic companies who have claimed a refund of the excess DDT paid by them vis-à-vis the beneficial DTAA rates as applicable to the shareholder are likely to be impacted by this ruling of the Tribunal. Further, since many multinationals have subsidiaries in India, the relevance of this issue is not just confined to India but is of global importance.

While reaching to the conclusion, the Tribunal has *inter-alia* placed reliance on the decision of the Supreme Court in the case Godrej & Boyce Mfg. Co. Ltd. (*supra*), wherein the Supreme Court, in the context of disallowance under Section 14A of the Act in the hands of shareholders, has held that DDT paid by the Indian company under Section 115-O of the Act cannot be treated as tax paid by the Indian company on behalf of its shareholders.

Hence, it will be of utmost importance to keep an eye out for the High Court's decision, as to whether it reaches to a similar conclusion as made by the Tribunal Special Bench or adopts a different one considering the arguments put forth on behalf of the taxpayers before the Special Bench.

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