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TAX TREATY OVERRIDES DIVIDEND DISTRIBUTION TAX PAYABLE BY DOMESTIC COMPANIES, RULES TAX TRIBUNAL

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In a landmark ruling, the Delhi bench of the Income Tax Appellate Tribunal (Tribunal) in the case of *Giesecke & Devrient Pvt Ltd* (Taxpayer) *v. The Additional CIT* (ITA No. 7075/DEL/2017), held that the Dividend Distribution Tax (DDT) payable by an Indian company should not exceed the rate specified in the applicable tax treaty between India and the country of tax residence of the shareholder.

BACKGROUND

Until 31 March 2020, dividend income was exempt in the hands of the non-resident shareholders and the company paying the dividends was required to pay additional corporate tax in the form of DDT at an effective and flat rate of `21% (the rate has undergone changes over the years since introduction and this was the last effective rate) without having any regard to the tax rate applicable to shareholders. The policy objective of introduction of DDT in the year 1997 was to ensure administrative convenience by having a single point of tax collection.

Since DDT was payable by Indian companies and not the non-resident shareholders for whom dividend income was exempt, applicability or relevance of beneficial rates under tax treaties was doubtful.

Starting 1 April 2020, the DDT regime has been abolished, thereby shifting the tax incidence from the company to the shareholders. It was recognised that dividend is income in the hands of the shareholders and not in the hands of the company and therefore, the incidence of the tax should be on the shareholders. Given the recent change in law, this ruling is relevant for the year 2019-20 and prior years.

The year in question in the recent decision was 2012-13. The Taxpayer, a wholly owned subsidiary of a German company, filed an additional ground of appeal during the ongoing appellate proceedings before the Tribunal relating to certain transfer pricing adjustments, claiming that the rate of DDT should not exceed the rate specified in the India – Germany tax treaty (Germany Treaty).

TRIBUNAL RULING

The Tribunal admitted the additional ground of appeal and held that the DDT payable by the Taxpayer should not exceed the rate specified in the Germany Treaty based on the following principles:

DDT payable by company but is a charge on dividends and borne by shareholders

The Tribunal, from a conjoint reading of the explanatory memorandums to the Finance Bills of 1997, 2003 and 2020 noted that although DDT is considered a tax on the company, it was introduced merely for simplifying administrative concerns by making tax collection easier and was not driven by any legal necessity. It was also noted that DDT was for all intent and purposes a charge on dividends. In terms of economic considerations, the burden of DDT falls on the shareholders as the amount of distributable surplus stands reduced to the extent of DDT. Therefore, the Tribunal held, that the mere fact that the liability of DDT falls on the company may ***not be considered relevant*** with respect to the applicability of rates of tax on dividend set out in the tax treaties with countries of tax residence of the shareholders.

Tax treaty prevails

Since DDT is an additional tax which is covered under the charging section ie section 4 of the Income Tax Act 1961 (IT Act), it is subject to section 90 of the IT Act. Section 90 of the IT Act states that in case of a conflict between the provisions of the IT Act and any tax treaty, the provisions of the tax treaty shall prevail if the same are more beneficial.

Further, the Tribunal noted that DDT was introduced in the IT Act in the year 1997, while the Germany Treaty was notified in the year 1996 and it provided that where the recipient is the beneficial owner of dividend income, the tax to be charged on dividends shall not exceed 10% of the gross amount of the dividend. The Tribunal referred to the case of *Skies Satellites (382 ITR 114)* wherein the Delhi High Court held, that in the context of tax treaties, which are a bargain between two sovereign states, the parliament is not equipped with the power to amend a treaty unilaterally by making an amendment in the domestic law. The Delhi High Court also referred to the obligations of a state under the Vienna Convention on the Law of Treaties (VCLT) which prevents a country from unilaterally amending an international treaty by amending the domestic laws of that country.

Relying upon this decision, the Tribunal held that since DDT was introduced after the Germany Treaty was enforced, the tax rates specified in the tax treaty must prevail over the DDT specified under the IT Act. The Tribunal referred the matter back to the tax officer, to examine and confirm the factual position that the Taxpayer was not carrying out any business (through a 'permanent establishment') in India to which dividend income could be attributed in which case the reduced rate of 10% as applicable under the Germany Treaty cannot be availed by the Taxpayer.

COMMENTS

This ruling being the first decision on the issue marks a landmark development on whether tax treaties can restrict the tax payable by an Indian company - where the tax incidence is on an Indian entity and not the non-resident earning income from India. The fundamental aspect which forms the basis of the Tribunal's decision is that though the tax is recoverable from the Indian company, it is effectively borne by the shareholder and it is a charge on dividend income.

Whether this interpretation conflicts with the purpose of introduction of DDT (administrative ease and not having to see individual shareholder positions) and also, if it could be extended to taxation of residents (who may be subject to an effective tax lower than DDT) are some questions left open. It would also be interesting to see if similar reasoning can be extended to tax payable by Indian companies on buy-back of shares, where the income is exempt in the hands of the shareholders.

The ruling does open the door for taxpayers to evaluate and claim a refund of DDT paid in the past with respect to dividends distributed to non-resident shareholders in excess of the tax rate provided for in the applicable tax treaties. With respect to such claims, there are various considerations at play, such as: (i) for how many past years can the refund claim be made; (ii) in case of ongoing tax proceedings, at what stage and in what manner a refund claim should be initiated (for instance in this ruling, the issue was raised as an additional ground of appeal before the Tribunal); (ii) who should be filing for the refund claim as the DDT is paid by the Indian entity and not the shareholder; and (iv) analysing treaty eligibility of the non-resident shareholders before making a claim.

Lastly, whether the tax department will challenge this ruling before the High Court and whether the High Court / Supreme Court will resonate with the reasoning of the Tribunal should be watched closely.

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