DIVIDEND INCOME FROM INDIA: TAX TREATY ISSUES FOR NONRESIDENT SHAREHOLDERS

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INTRODUCTION

Prior to April 1, 2020, dividend income of nonresident shareholders of an Indian company was exempt from tax in India. However, Indian companies paid dividend distribution tax (the "D.D.T.") on the payment of a declared dividend. That changed in April 2020, when dividend income of shareholders became taxable in India in the hands of such shareholders. For dividends paid to nonresident shareholders, Indian companies must withhold appropriate withholding tax when paying dividends.

The rate of direct tax and withholding tax on dividend income of nonresidents, as per Indian Income Tax Act 1961 (the "Act") is 20%, plus applicable surcharge and cess. A taxpayer is permitted to apply the provisions of a tax treaty, if such provisions are more beneficial than the provisions of the Act.[1] The nonresident shareholder must furnish a tax residency certificate ("T.R.C.") from the tax authority of its country of residence along with other documentation to claim tax treaty benefits in India.

Prior to the change in law, the issue of claiming tax treaty benefits in India for Indian dividend income was not relevant. Consequently, neither the existence of tax nexus over a shareholder nor the shareholder's residence country were relevant issues. Now, however, nonresident shareholders face several issues when seeking relief from withholding tax under an income tax treaty in effect between India and a particular treaty partner. This article aims to provides insights into typical situations and issues being faced.

TAX TREATY RELIEF FOR DIVIDENDS

India has in effect income tax treaties with over 90 countries. Generally, the withholding tax rate on dividend income is lower under an income tax treaty than that provided under domestic law. In addition, several of India's tax treaties contain a most-favored-nation ("M.F.N") clause. The M.F.N. clause permits a qualifying tax resident of the treaty partner country to apply a lower withholding tax under an income tax treaty between India and another treaty partner country, provided that the other country is a member of the O.E.C.D. The language of the M.F.N. clause varies among the income tax treaties in effect. In particular, some provide that its application is automatic, while others provide that the benefit depends on further agreement between tax authorities of both countries.

Hence, it is in the interest of nonresident shareholders to seek access to the applicable tax treaty and reduce their tax liability in India, if possible. Broadly speaking, the tax rates under some of India's popular tax treaties, without considering the M.F.N. clause, are as follows:

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[1] Section 90(2) of the Act.

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Country	Tax Rate on Dividend Income
United States	15% (25%, depending on facts)
United Kingdom, Singapore	10% (15%, depending on facts)
Belgium *(M.F.N. clause)*	15%
France, Hungary, Netherlands, Switzerland, Sweden *(all with M.F.N. clause)*	10%
Germany	10%
Portugal	10% (15%, depending on facts)
Mauritius	5% (15%, depending on facts)
Slovenia, Lithuania	5% (15%, depending on facts)
Colombia	5%

As the above table indicates, the tax rates on dividend income from India can be reduced under an income tax treaty from 20%, plus applicable surcharge and cess, to as low as 5%. However, Indian tax authorities can invoke the provisions of India's General Anti-Avoidance Rule ("G.A.A.R.") in certain circumstances to deny the tax treaty benefit in India if they find that the main purpose of the arrangement is to obtain an impermissible tax benefit in India considering the principle of substance over form.

TAXATION OF DIVIDEND INCOME UNDER SELECT INCOME TAX TREATIES

Mauritius

Historically, Mauritius has been one of the most popular jurisdictions for routing investments to India. The rate is 5%, if the beneficial owner is a Mauritius company that directly holds at least 10% of the capital of the Indian company paying the dividends. The rate is 15% in all other cases.

The Multilateral Instrument ("M.L.I.") does not yet apply to the India-Mauritius Income Tax Treaty. While ratifying the M.L.I., Mauritius has not covered the treaty with India. Accordingly, the principal purpose test ("P.P.T.") under the M.L.I. does not apply to the India-Mauritius tax treaty.

Coupled with the tax regime in Mauritius, Mauritius continues to be a favored jumping-off point for making a direct investment in shares of an Indian company. Nonetheless, the provisions of India's G.A.A.R. should be analyzed before structuring investments through Mauritius. Also, if the M.L.I. becomes applicable to the India-Mauritius tax treaty in the future, the requirement of economic and commercial substance under the P.P.T. test will be crucial for availing tax treaty benefits in India.

United States

The rate of tax on dividend is 15%, if the beneficial owner is a U.S. corporation that owns at least 10% of the voting stock of the Indian company paying dividends. The rate is 25% in all other cases.

Although the U.S. has not ratified the M.L.I., Article 24 (Limitation on Benefits) of the India-U.S. Income Tax Treaty provides a set of simplified limitation on benefits ("L.O.B.") tests that must be met in order for a corporation to claim the benefit of the treaty.

Under the first test, a U.S. tax resident other than an individual must meet the following ownership and base erosion tests. More than 50% of the beneficial interests in the entity must be owned directly or indirectly by

- one or more individual residents of India or the U.S.;
- one of the Contracting States, including political subdivisions or local authorities;
- other individuals subject to tax in India or the U.S. on worldwide incomes; or
- citizens of the U.S.

Under the base erosion test, the income of the entity must not be used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not

- residents of the U.S. or India;
- residents of one of the Contracting States, including political subdivisions or local authorities; or
- citizens of the U.S.

Under the second test, the income from India must be derived in connection with, or be incidental to, the active conduct by the U.S. corporation of a trade or business in the U.S., other than the business of making or managing investments. Under an exception, activities carried on in the banking or insurance sectors are acceptable.

Under the third test, a U.S. corporation will qualify for treaty benefits if its principal class of shares are publicly traded. This means that there is substantial and regular trading on a recognized stock exchange, including NASDAQ and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934.

If none of the foregoing tests are met, a U.S. corporation may make a request to the Indian competent authority for relief and access to treaty benefits.

Limited liability companies ("L.L.C.'s") may qualify for treaty benefits based on certain judicial precedents even though most are treated as passthrough entities in the U.S. that do not pay U.S. tax and are not tax resident in their own right. This implies that, for treaty benefits to be granted, the owner of an L.L.C. must (i) be a

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corporation[2] other than an S-corporation,[3] (ii) be formed under the laws of a state of the U.S., (iii) actually pay tax in the U.S. on global income,[4] and (iv) meet the conditions of the India-U.S. Income Tax Treaty, including the L.O.B. clause. If those facts exist, a *pro rata* portion of the dividend may qualify for the reduced rate of withholding tax. Even then, a challenge from the Indian tax authorities may arise and G.A.A.R. can still be invoked to deny tax treaty benefits.

The U.K. or Singapore

Under the India-U.K. Income Tax Treaty, the rate of withholding tax that is imposed on dividend payments from an Indian company generally is 10%, although it may be 15% certain limited circumstances.

Under the India-Singapore Income Tax Treaty, the rate of tax on dividend payments from an Indian company is 10%, if the beneficial owner is a Singapore company that owns at least 25% of the shares of the Indian company paying the dividends. In all other cases, the rate is 15%.

Entitlement to the reduced tax rate is subject to potential challenge under Indian domestic G.A.A.R. In addition, the M.L.I. has been adopted in both income tax treaties and the treaty P.P.T. must be met as well. Consequently, the benefit of reduced withholding tax rates under each income tax treaty may be lost if the Indian tax authorities conclude that, having regard to all relevant facts and circumstances, it is reasonable to conclude that obtaining that benefit was one of the principal purposes of arranging an investment in India through a Singapore or U.K. corporation, provided that the reduced rate of withholding may be allowed if considered to be in accordance with the object and purpose of the treaty.

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The Netherlands

Under the India-Netherlands Income Tax Treaty, the rate of withholding tax on a dividend from an Indian company is 10%. However, a possibility exists to invoke the M.F.N. clause under the income tax treaty in order obtain the benefit of a 5% rate, as was discussed before the Delhi High Court in the case of a Netherlands taxpayer.

In the *Concentrix Services Netherlands B.V.* case,[5] the Indian tax authorities were unsuccessful in defending their action of denying application of the M.F.N. benefit. The taxpayer was a tax resident of Netherlands and a shareholder of an Indian company which was making payment of a dividend at a time when the D.D.T. was no longer in effect. The taxpayer made an application to the Indian tax authorities

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[2] If the shareholder in the U.S. is not a corporation that would qualify for the 15% rate of withholding tax, the withholding tax rate under Indian domestic law is lower than the treaty rate.

[3] An S-corporation is a corporation that generally is owned only by U.S. citizens and resident individuals. It elects flow through treatment under Subchapter S of the Internal Revenue Code.

[4] In principle, the dividend may qualify for the dividends received deduction that is provided under Section 245A of the Internal Revenue Code.

[5] W.P.(C) 9051/2020.

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seeking the benefit of the M.F.N. under the India-Netherlands Income Tax Treaty signed in 1989. The taxpayer contended that the lower tax rate of 5% for dividend income under the India-Slovenia Income Tax Treaty signed in 2003 was available to it. Further, the 5% withholding tax rate provided for in the India-Lithuania Income Tax Treaty signed in 2011 and the India-Colombia Income Tax Treaty signed in 2011 would be imported into the India-Netherlands tax treaty under the M.F.N. clause, as each of those countries were O.E.C.D. members as of the date the taxpayer sought to apply the M.F.N. clause. Nonetheless, the Indian tax authorities denied the application because none of those countries was a member of the O.E.C.D. when its income tax treaty with India was signed. The tax authorities argued that no intention existed to extend the rate of withholding tax in those income tax treaties to existing treaties with other countries once those other countries became members of the O.E.C.D.

The Delhi High Court disagreed with the position of the Indian tax authorities and held that the benefit of the lower tax rate of 5% for dividend income under the three income tax treaties was available to Concentrix because it was a Dutch resident corporation entitled to treaty benefits and all of the countries were O.E.C.D. members at the time the M.F.N. clause in the treaty applicable to Concentrix was sought to be invoked.

The Delhi High Court also placed reliance on the Decree issued by the Netherlands authorities which stated that the lower tax rate of 5% for dividend income under the India-Slovenia tax treaty would apply to the India-Netherlands tax treaty. Hence, it was held that India could not adopt an inconsistent position in light of applicable treaty interpretation principles.

Nonetheless, the Indian tax authorities have not relinquished the position raised in the *Concentrix* case. A similar Delhi High Court judgment is currently before the Supreme Court.[6] The issue will be settled once the Supreme Court rules. In the interim, the position of the tax authorities is troublesome. A tax circular has been issued disagreeing with the rationale of the Delhi High Court. It contends that the M.F.N. clause cannot be applied automatically irrespective of its language unless an explicit notification is made by India. The circular is not binding on taxpayers. However, it will be followed by the tax authorities. Until the matter is finally settled, only taxpayers that have received a favorable order from any court in India can follow the holding in the *Concentrix* case without risk of assessment. Note that a subsequent decision of the Income Tax Appellate Tribunal ("I.T.A.T.") has held that the Circular may not be in line with the law.

In these circumstances, a corporation that is resident of a country having an income tax treaty with India that includes an M.F.N. provision may wish to explore the option of invoking the Mutual Agreement Procedure ("M.A.P.") of that treaty. Even then, the impact of the Indian G.A.A.R. and the P.P.T. under the India-Netherlands Income Tax Treaty would need to be analyzed. Also, the effect of differences among the three treaties providing a 5% withholding tax rate on direct investment dividends requires analysis. The 5% tax rate under India-Slovenia Income Tax Treaty and India-Lithuania Income Tax Treaty is available only if the beneficial owner directly holds at least 10% of the capital of the Indian company paying the dividends. No similar requirement exists in the India-Netherlands Income Tax Treaty. It is not clear whether the 10% ownership requirement of other treaties must be imported under other treaties along with the 5% withholding tax rate.

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[6] The Nestle SA case is discussed below in the text at note 7.

Finally, the conditions under the India-Slovenia Income Tax Treaty to qualify for the 5% withholding tax rate have been modified by Article 8 of the M.L.I., which requires the 10% shareholding to be met throughout a 365-day period that ends on the date of payment of the dividend. Article 8 of the M.L.I. does not apply to the India-Netherlands Income Tax Treaty. In the context of a parent company owning all the shares of an Indian subsidiary, this is not a problem. But it may be a problem for a Dutch company owning less than 10% of an Indian company when invoking the M.F.N. clause under the India-Netherlands Income Tax Treaty.

"The M.L.I. does not apply to the India-Switzerland Income Tax Treaty."

Switzerland

Under the India-Switzerland Income Tax Treaty, the rate of dividend withholding tax is 10% and a possibility exists to invoke an M.F.N. provision in the treaty to claim a reduction in withholding tax to 5%.

As mentioned above, after the judgment in the *Concentrix* case, the Delhi High Court gave similar access to the lower dividend withholding tax rate of 5% for dividend income in the *Nestle SA* case,[7] involving the M.F.N. provision under the India-Switzerland Income Tax Treaty. There, the Delhi High Court referred to the withholding tax rate for dividends under the India-Lithuania Income Tax Treaty and the India-Colombia Income Tax Treaty. Subsequently, the Swiss tax authorities officially notified Swiss taxpayers that the withholding tax rate of 5% is applicable on receipt of dividend income from Indian companies. As a result, the foreign tax credit in Switzerland is capped at 5%. Reciprocity from the Indian tax authorities in this matter is expected by Switzerland.[8] As mentioned previously, the Indian tax authorities do not share this view.

The M.L.I. does not apply to the India-Switzerland Income Tax Treaty. Consequently, the P.P.T. and Article 8 of the M.L.I. have no impact on dividends paid to a Swiss corporation.

Cayman Islands and British Virgin Islands ("B.V.I.")

Income tax treaties are not in effect between India and the Cayman Islands or B.V.I. Accordingly, dividends paid to residents of these jurisdictions are subject to full Indian withholding tax of 20%, plus applicable surcharge and cess. Currently, there is much discussion about a potential redomicile of Cayman Islands and B.V.I. corporations to Mauritius. Mauritius is a business-friendly jurisdiction that has a favored tax regime for corporation and an income tax treaty in effect with India. Ideally, the redomicile of a corporation to Mauritius should not be considered a taxable event for a corporation holding shares of an Indian company. Nonetheless, a question arises whether the redomiciliation will adversely impact the redomiciled company's entitlement to income tax treaty benefits in India based on claims of treaty shopping or avoidance under a P.P.T. standard.

Recently, the Mumbai bench of the I.T.A.T. addressed the issue in the *Asia Today Limited* case.[9] In reaching its decision in a case involving redomiciliation, it acknowledged that various dynamic and constantly evolving business reasons and

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7 W.P. (C) 3243/2021.

8 Announcement of the Swiss Federal Department of Finance on August 13, 2021.

9 TS – 620-ITAT-2021 (Mum).

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justifications may exist for redomiciliation, especially if the existing place of domicile inhibits future business or prospects in some way. In this regard, it reflected a view in the U.S. that entering a transaction for good and valid business purposes will not be tainted under a P.P.T. standard if the good and valid business purpose is merely enhanced by a resulting tax saving.[10]

CONCLUSION

The D.D.T. system was enacted to allow India to collect tax on dividend distributions at the rate it determined without regard to limitations under its network of income tax treaties. Now that the D.D.T. has been repealed, India once again faces limitations on its ability to fully tax dividend distributions to nonresidents. It has taken a position that M.F.N. provisions have only limited application. Whether that position can be maintained at a time of international cooperation is an open question. Interesting times.

[10] See for example Code §7701(o), codifying the economic substance doctrine of U.S. tax law. The provision does not alter the tax treatment of certain basic business transactions that, under longstanding judicial and administrative practice, are respected. Among these basic decisions are (i) the choice between capitalizing a business enterprise with debt or equity, (ii) the choice between foreign corporations and domestic corporations, (ii) the treatment of a transaction or series of transactions as a tax-free corporate organization or reorganization, and (iv) the ability to respect a transaction between related parties provided that the arm's length standard of Code §482 is satisfied.

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