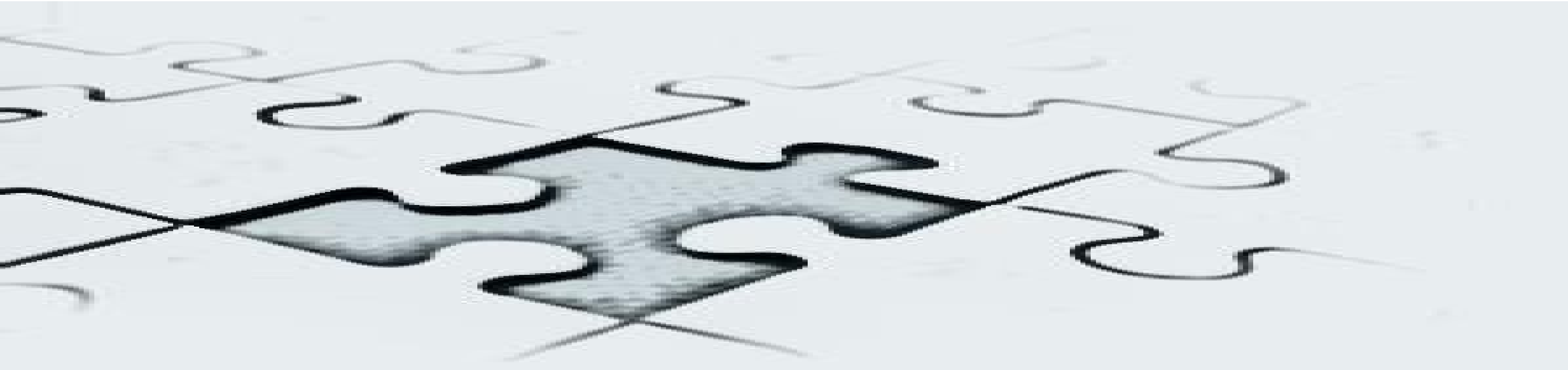
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

Workshop on International Taxation for Beginners



DIVIDENDS, INTEREST & CAPITAL GAINS (ARTICLE 10, 11 AND 13)

CA SIDDHARTH BANWAT

ARTICLE 10 – DIVIDEND : A BRIEF SNAP-SHOT

- **ARTICLE 10(3) –** DEFINES THE TERM ‘DIVIDEND’
- **ARTICLE 10(1) –** DEALS WITH DISTRIBUTION RULE
- **ARTICLE 10(2) –** GRANTS RIGHT TO TAX IN SOURCE COUNTRY
- **ARTICLE 10(4) –** DEALS WITH PE EXCLUSION
- **ARTICLE 10(5) –** PROHIBITS EXTRA TERRITORIAL TAXATION

ARTICLE 10 (1) - MEANING OF DIVIDEND

- Paragraph 3 of Article 10 provides that the term "dividends" as used in Article 10 means income from shares or other rights not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

- **OECD Model 2014**

  The term "dividends" as used in this Article means
  - income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares; or
  - other rights, not being debt-claims, participating in profits, as well as
  - income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

- **US Model 2006**

  For purposes of this Article, the term "dividends" means
  - income from shares, or
  - other rights, not being debt-claims, participating in profits, as well as
  - income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident.

ARTICLE 10 (1) – TAXABILITY BY RESIDENT COUNTRY

- Paragraph 1 of Article 10 lays down the principle that dividend **paid** by a company which is resident of a Contracting State (say country S) to a resident of the other Contracting State (say Country R) **may** be taxed in that other state (i.e. in country R).

- Paragraph 2 of Article 10 lays down that dividend **may be taxed** in the Contracting State of which the company paying the dividends is a resident (i.e. in country S) and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (i.e. country R), tax shall not exceed ….

MEANING OF 'PAID'…

- **Article 10(1) - Meaning of 'paid'…**

  OECD commentary (Para 7 of Article 10) − The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or custom.

- Article 3(2) - terms not defined in Tax Treaty - meaning as per domestic tax laws

  •Section 43(2) - 'Paid' means actually paid or incurred according to the method of accounting

  •Section 8 – Dividend Income

    For the purposes of inclusion in the total income of an assessee,—
    (a) any dividend declared by a company or distributed or paid by it within the meaning of sub-clause (a) or sub-clause (b) or sub-clause (c) or sub-clause (d) or sub-clause (e) of clause (22) of section 2 shall be deemed to be the income of the previous year in which it is so **<u>declared, distributed</u>** or paid, as the case may be (b) any interim dividend shall be deemed to be the income of the previous year in which the amount of such dividend is unconditionally made available by the company to the member who is entitled to it.

MEANING OF 'PAID'…

- Section 9(1)(iv) provides that dividend paid by an Indian company outside India shall be deemed to accrue or arise in India. Hence dividend paid by Indian company outside India constitutes income deemed to accrue in India u/s 9(1)(iv)

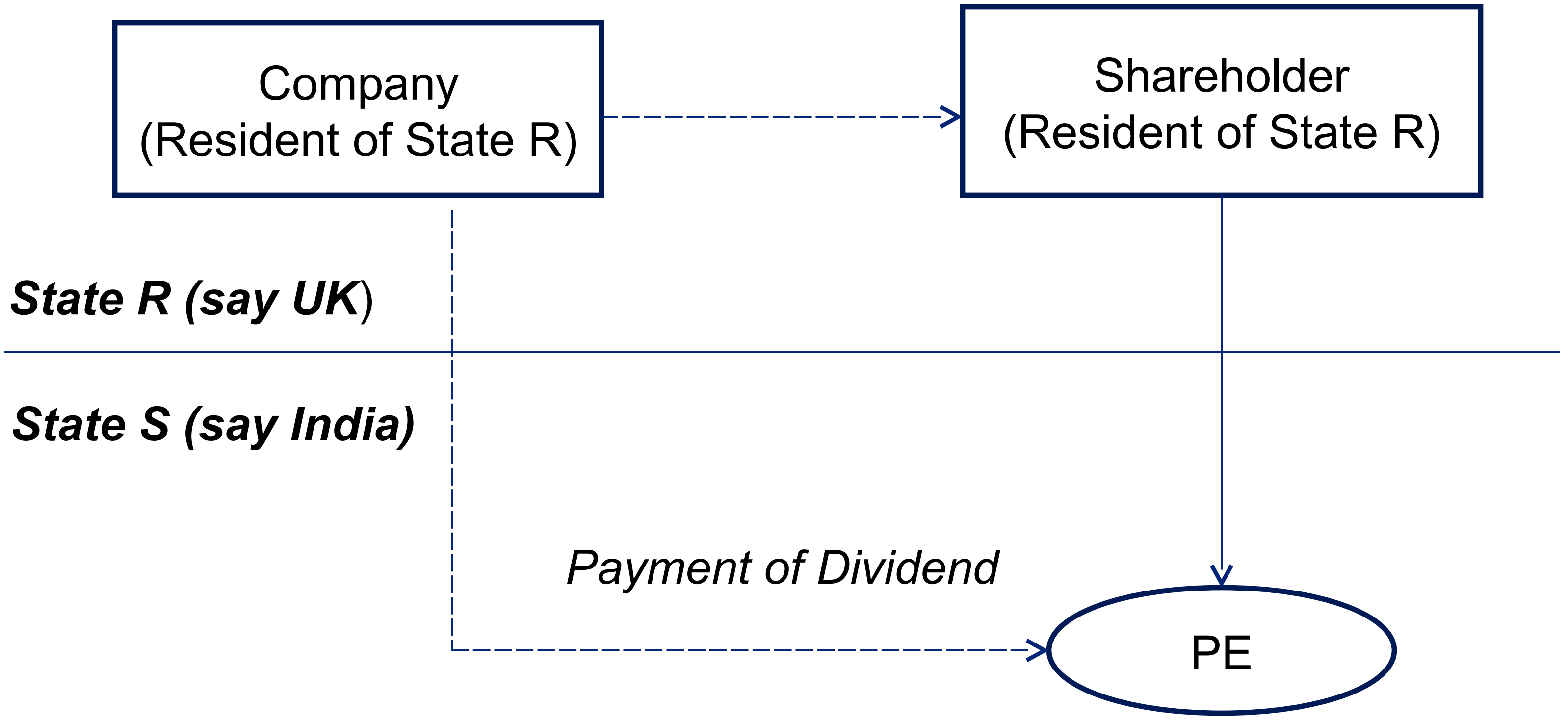
- Section 2(22)(a), (b), (c), (d) dealing with deemed dividend provisions uses the word 'distribution' , while section 2(22)(e) uses the word 'payment'

- Credit entry in books of payer to account of payee amounts to its receipt by payee
  - CIT v. Standard Triumph Motor Company Ltd. (201 ITR 391)(SC)
  - Bombay HC decision in case of Pfizer Corpn. v. CIT (259 ITR 391)

- 'Declared or distributed' occurring in section 8 do not find place in section 9(1)(iv)

- Dividend paid by an Indian company outside India deemed to accrue in India only on payment and not on declaration

ARTICLE 10 – CASE STUDY 1



- Article 10(1) will not apply since dividend not declared by company resident of State S

ARTICLE 10 (2) – TAXABILITY BY SOURCE COUNTRY

- Paragraph 2 of Article lays down that dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident (i.e. in country S) and according to the laws of that State (i.e. Country S), but if the recipient is the beneficial owner of the dividends, the tax so charged shall not exceed:

  (a) XX% of the gross amount of the dividends if the **beneficial owner** is company which holds directly at least YY% of the capital of the company paying the dividends;

  (b) XX% of the gross amount of the dividends in all other cases

- Grants Right to tax in Source Country

- Taxation in source country according to its Domestic Law

- Exception - If beneficial owner is the resident

  - Limited right to tax in Source Country on gross basis

  - FDI / Portfolio Investment

- Article does not affect the taxation of the company

MEANING OF 'BENEFICIAL OWNER'…

- Treaty meaning v. domestic law meaning

- Different approaches:
  - Legal meaning: Who owns the income in a strictly legal sense
  - Common law definition: person whose ownership attributes outweigh that of any other person
  - Substance over form approach: construed in the light of object and purpose of Treaty. Free to avail capital or assets and / or yields from such capital or assets
  - Liable to tax test: to whom income is allocated for tax purposes by its R State

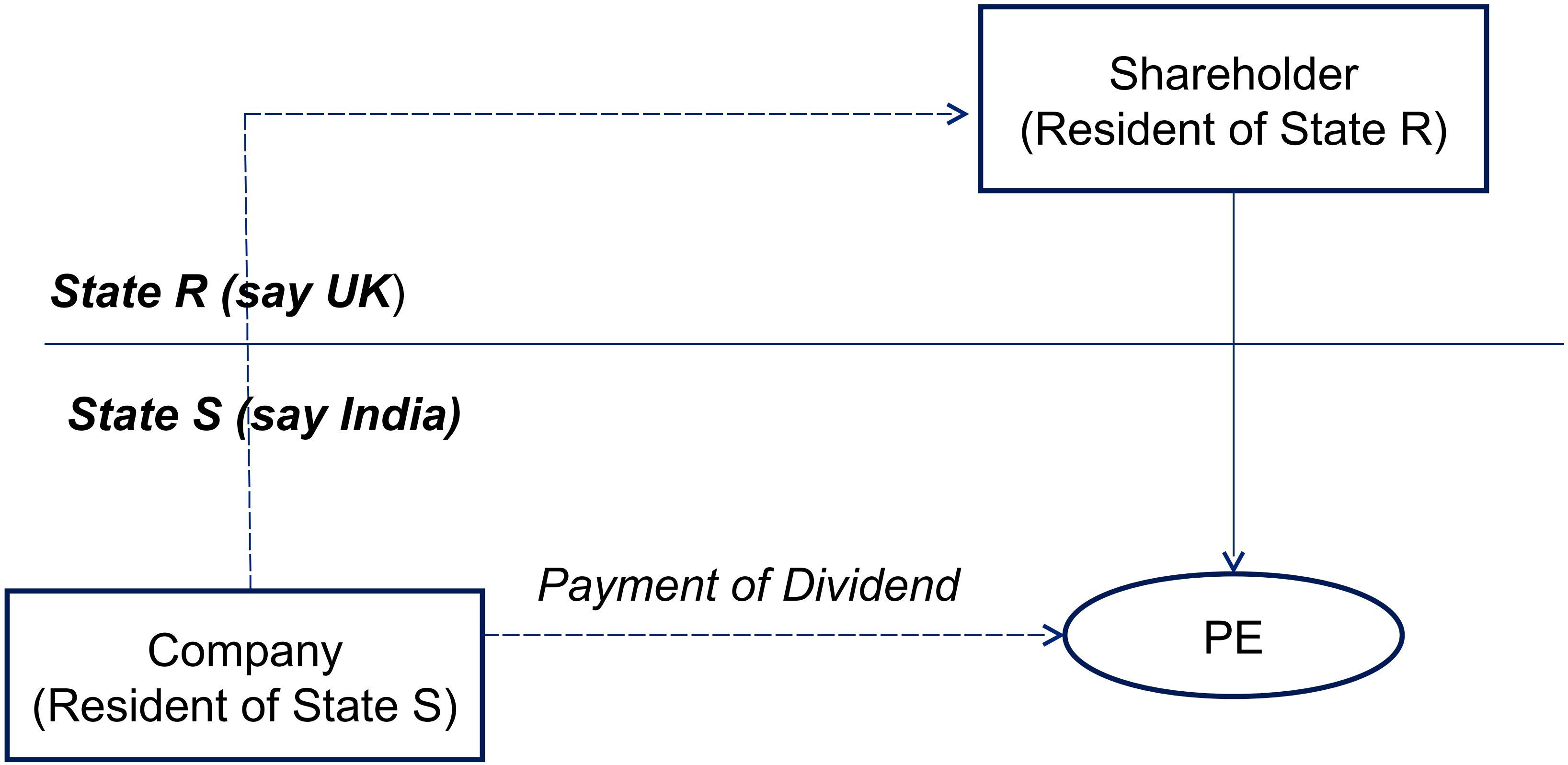
- **Clarification on meaning of beneficial ownership in the OECD MC**

  − the recipient of the dividend is not the "beneficial owner" because that recipient does not have the full right to use and enjoy the dividend that it receives and this dividend is not its own; the powers of that recipient over that dividend are indeed constrained in that the recipient is obliged (because of a contractual, fiduciary or other duty) to pass the payment received to another person. The recipient of a dividend is the "beneficial owner" of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment received to another person.

ARTICLE 10 (4) – DEALS WITH PE EXCLUSION

- Provisions of Para 1 and 2 not to apply when
  - beneficial owner of Dividend
  - Carries on business/performs services in the source country through a PE / fixed base
  - the holding is ‘effectively connected ‘ with such PE or fixed base
- Result
- Meaning of effective connection

ARTICLE 10 – CASE STUDY 2



- Article 10(4) will apply
- State S can tax the same as Business Profits under Article 7 in case of a PE or Independent Personal Services under Article 14 in case of a Fixed Base

ARTICLE 10 (5) – PROHIBITS EXTRA TERRITORIAL TAXATION

- It is based on the principle that Source Country should not tax the dividend distributed by non-resident company to shareholders merely because such non-resident company derives its corporate profit that originated in Source Country

- To say, this article prohibits the right of Country A to tax the dividend paid by a Company in Country B to its shareholders even though such dividend is paid out of profit arising / accruing in Country A except;

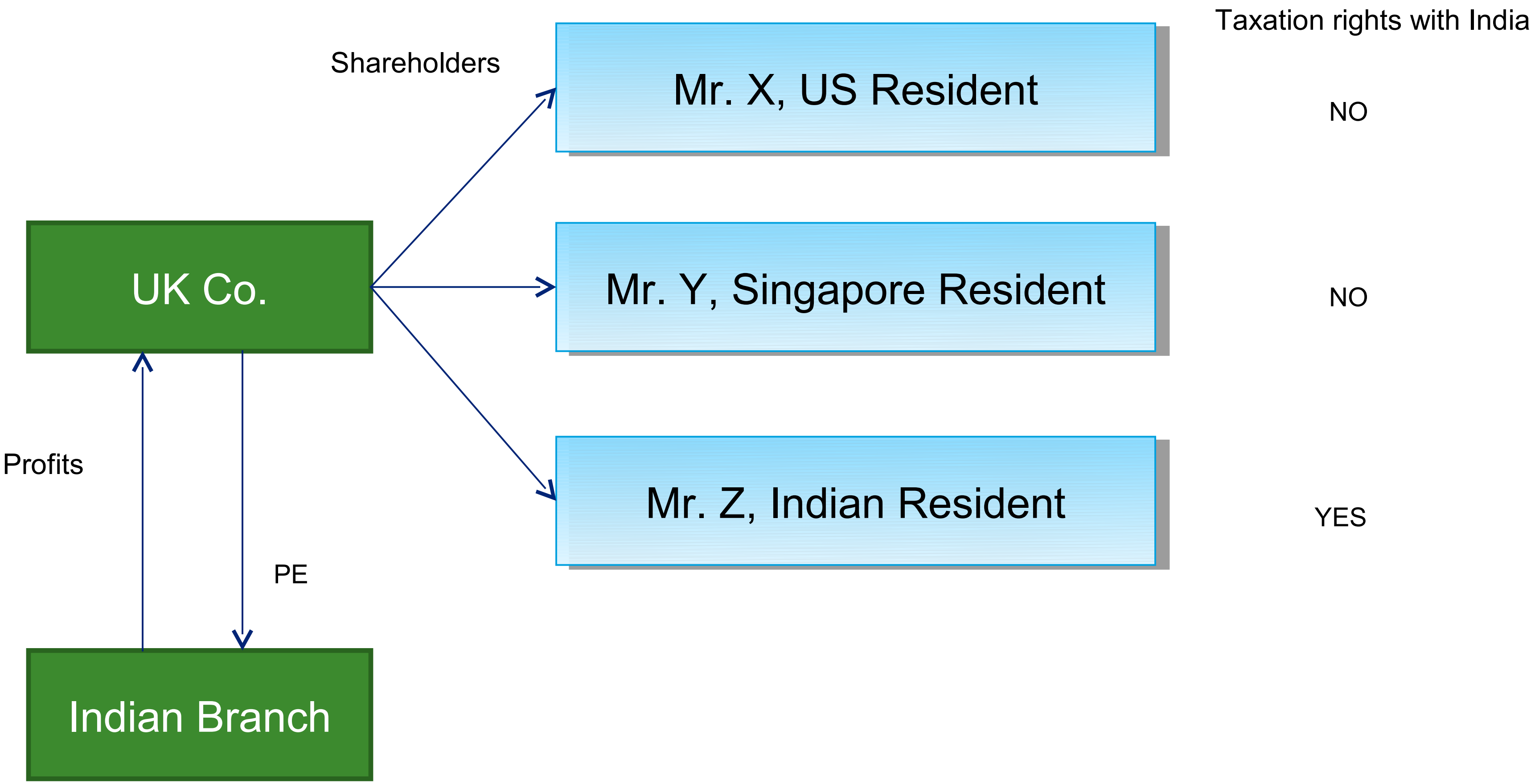
  (a) Dividend is distributed to shareholders of Country A;

  (b) Dividend is effectively connected with PE of the company in Country A.

  In this way, article 10(5) prohibits such ‘extraterritoriality’ with respect to taxation of dividend.

- Also prevents imposition of tax on the undistributed profits of a non resident company

ARTICLE 10 – CASE STUDY 2



ARTICLE 11 – INTEREST : A BRIEF SNAP-SHOT

- **ARTICLE 11(3) –** MEANING OF ‘INTEREST’
- **ARTICLE 11(1) –** DEALS WITH DISTRIBUTION RULE
- **ARTICLE 11(2) –** GRANTS RIGHT TO TAX IN SOURCE COUNTRY
- **ARTICLE 11(4) –** DEALS WITH PE EXCLUSION
- **ARTICLE 11(5) –** DEFINES THE ‘SOURCE’
- **ARTICLE 11(6) –** RELATED PARTY TRANSACTIONS – ARM’S LENGTH PRINCIPLE

ARTICLE 11 (3) - MEANING OF INTEREST

- Paragraph 3 of Article 11 provides that the term “interest” means

  - Income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits,
  - and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.
  - Penalty charges for late payment shall not be regarded as interest for the purpose of this article.

- **Sec 2 (28A)** of the Income Act, 1961 provides that “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

- **Sec 2 (28A)** of the Income Act, 1961 provides that “interest on securities” means interest on any security of the Central Government or a State Government ; 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.

ARTICLE 11 (1) – DISTRIBUTION RULE

- Paragraph 1 of Article 11 lays down the principle that interest **<u>arising</u>** in a Contracting State (say country S) and paid to a resident of the other Contracting State (say Country R) **<u>may</u>** be taxed in that other state (i.e. in country R).

- OECD commentary - no exclusive right of taxation of interest either to country R or country S

- Article 11(5) provides that interest is <u>deemed to arise in the Contracting State if "payer" is resident of that Contracting state</u>

  − Exception to the above rule:
  If the payer of interest has PE in a contracting state; and
  the interest is actually borne by a PE of the payer in that Contracting State; then
  Such contracting state has right to tax the interest borne by such PE

ARTICLE 11 (2) – RIGHT OF TAXATION IN SOURCE COUNTRY

- Paragraph 2 of Article lays down that interest may also be taxed in the Contracting State in which it arises and according to the laws of that State (i.e. Country S), but if the recipient is the beneficial owner of the interest, the tax so charged shall not exceed:

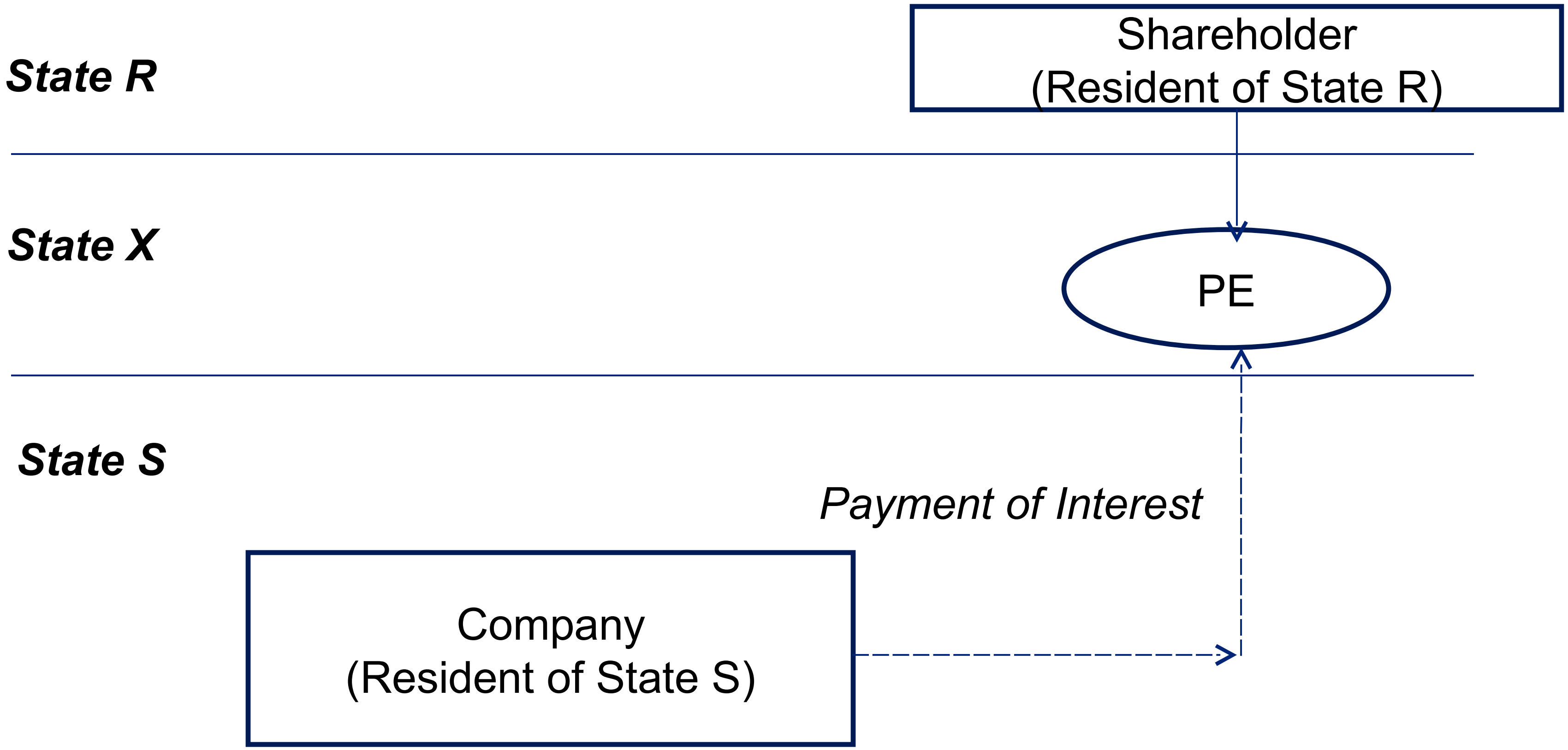
  (a) XX% of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company) ;

  (b) XX% of the gross amount of the interest in all other cases

- Right to taxation by the Country S usually subject to a limit – usually 10% or 15%. Concessional rate of taxation subject to certain conditions:

- Recipient of interest - resident of country R and beneficial owner of interest

ARTICLE 10 – CASE STUDY 2



- State S to apply concessionary rate as treaty with State R

ARTICLE 11 (4) – DEALS WITH PE EXCLUSION

Provisions of Para 1 and 2 not to apply when

•Beneficial owner of Interest

- Carries on business in Source country
- Through Permanent Establishment (PE) / Fixed Based and

•Debt claim in respect of which interest is paid is ‘effectively connected’ with –

- The PE / fixed base
- Business activities referred to in Article 7 (1) (c)

Result

Effective Connection - Meaning

ARTICLE 11 (5) – DEALS WITH PE EXCLUSION

1. Section 9(1)(v) ITA - Interest deem to accrue or arise if payable by
   a) Government
   b) Resident – Exception
   c) Non Resident only if – borrowal / debt is for business purpose in India

2. DTAA – Payable by resident

3. Exception to (2)
   - Existence of PE of the payer
   - Liability to pay in connection with PE
   - Payment borne by PE

Result - Interest deem to arise where PE is situated

ARTICLE 11 (6) – ARM'S LENGTH PRINCIPLE

- Restrict operation of Article 11 to the amount of interest determined as per arm's length principle when special relationships exist

- 'Special Relationship' may exist
  - Where the interest is paid to a person who holds direct / indirect control over the payer;
  - Where there is a relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of interest

- Excess amount may be subjected to tax as per the domestic tax laws of each of the Contracting States

ARTICLE 13 – CAPITAL GAINS : A BRIEF SNAP-SHOT

- **ARTICLE 13(1):** GAINS - IMMOVABLE PROPERTY
- **ARTICLE 13(2):** GAINS - MOVABLE PROPERTY FORMING PART OF PE/PE
- **ARTICLE 13(3):** GAINS - SHIPS OR AIRCRAFT OPERATED IN INTERNATIONAL TRAFFIC
- **ARTICLE 13(4):** GAINS - SHARES OF COMPANY HOLDING IMMOVABLE PROPERTY
- **ARTICLE 13(5):** GAINS - SHARES OTHER THAN COVERED BY 13(4)
- **ARTICLE 13(6):** RESIDUAL GAINS

ARTICLE 13 – PREFACE

1. Taxation of capital gains varies considerably from country to country
   - Capital gains deemed not to be taxable
   - Gains accruing to an enterprise are taxable, but gains made by individuals outside the course of trade or business are not taxed
   - All capital gains whether related to the business of the assessee or not are taxable

1. Even in jurisdictions where capital gains is taxable, the levy itself varies
   - Taxed as ordinary income and added along with all other income.
   - Computation methodologies could vary
   - Select countries special rates are prescribed

ARTICLE 13(1) – CAPITAL GAINS FROM IMMOVABLE PROPERTY

1. Paragraph 1 of Article 13 lays down the principle that Gains derived by a resident of a Contracting State from the **alienation of immovable property** (say Country R), referred to in Article 6 and situated in the other Contracting State (say country S) may be taxed in that other State (i.e. in country S).

2. **Immovable properties referred in Article 6**

   In terms of Para 2 of article 6, the term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated i.e Country S. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships and aircraft shall not be regarded as immovable property.

ARTICLE 13(2) – CAPITAL GAINS FROM MOVABLE PROPERTY

1. Paragraph 2 of Article 13 lays down the principle that Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such fixed base, may be taxed in that other State.

ARTICLE 13(3) – CAPITAL GAINS FROM ALIENATION OF SHIPS AND AIRCRAFT

Paragraph 3 of Article 13 lays down the principle that Gains from the alienation of ships or aircraft operated in international traffic or movable property pertaining to the operation of such ships or aircraft shall be taxable only in the Contracting State of which the alienator is a resident.

ARTICLE 13(6) – ALIENATION OF ANY PROPERTY OTHER THAN THOSE MENTIONED IN PARAGRAPHS 1, 2 AND 3

Gains derived by a resident of a Contracting State from the alienation of any property other than those mentioned in paragraphs 1, 2 and 3 of this Article shall be taxable only in that State (i.e. Country S).

ARTICLE 13 IN SOME DTAA

- UK & USA DTAAs

  Taxable in both countries as per domestic law

- Netherlands DTAA
  - Gains from shares taxable only in Netherlands
  - If Dutch company holds at least 10% of Indian Co. gains taxable in India
  - Only if sale happens to Indian Resident
  - If sale happens to NR, then gain taxable only in Netherlands
  - Gain taxable only in Netherlands if realised in course of corporate organisation, reorganisation, amalgamation, division, etc., and buyer or seller owns at least 10% of the other co.'s capital
  - Not every transaction is reorganisation , Buyback held not to be a reorganisation [Accordis Beheer B V [2016] 66 taxmann.com 164 (Mumbai - Trib.)]

RECENT AMENDMENT IN ART 13 OF INDIA-MAURITIUS DTAA

The Protocol for amendment of the India-Mauritius Convention signed on 10th May, 2016,

- provides for <u>source-based taxation</u> of capital gains arising from alienation of shares acquired from 1st April, 2017 in a company resident in India.

- Simultaneously, <u>investments made before 1st April, 2017 have been grandfathered and will not be subject to capital gains taxation</u> in India.

- Where such capital gains arise during <u>the transition period from 1st April, 2017 to 31st March, 2019, the tax rate will be limited to 50% of the domestic tax rate of India</u>. However, the benefit of 50% reduction in tax rate during the transition period shall be subject to the Limitation of Benefits Article. Taxation in India at full domestic tax rate will take place from financial year 2019-20 onwards.

THANK YOU

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