Deduction of Tax at Source on Dividend

BACKGROUND

Dividend constitutes an important stream of income for shareholders of companies. The manner in which dividend income is taxed in India has undergone several changes over the years. In 1997, India introduced the Dividend Distribution Tax (DDT) regime wherein the company paying the dividend was liable to DDT and consequently dividend income was exempt in the hands of the shareholders replacing the earlier classical system.

However, this methodology was considered regressive and biased, as dividend is income in the hands of the shareholder and not in the hands of the company. In 2002, the incidence of dividend tax was shifted to the shareholders and in 2003 again shifted back in the hands of the company.

India has now re-introduced the classical system of taxing dividend income in the hands of shareholders by abolishing DDT through Finance Act 2020. As a result, the dividend received on equity shares and mutual funds which were earlier exempt is now taxable in the hands of the shareholder. Thus, provisions for Tax Deducted at Source (TDS) have also become applicable.

EXECUTIVE SUMMARY

Particulars	Rate of TDS	Remarks
Resident Shareholders	• 10% (presently reduced to 7.5% until 31st March 2021) if dividend amount exceeds INR 5,000 • 20% in absence of PAN	• No TDS if Form 15G/15H submitted • No TDS for specified Insurance companies/Mutual Funds and AIF
Non Resident Shareholders (Other than FPI)	20% plus applicable surcharge and cess or rates as per DTAA whichever is beneficial	• Surcharge restricted to maximum 15% • TRC to be obtained with declaration for PPT, beneficial ownership, No PE/POEM in India
FPI	20% plus applicable surcharge and cess	

Particulars	Rate of TDS	Remarks
Compliance Requirements		• Filing TDS Return and Issuing TDS Certificates • Form 15CA in case of all payment to Non Residents • CA Certificate in Form 15CB in case payment to Non Residents exceeds INR 5 Lakhs

APPLICABILITY

TDS on dividend is applicable on all dividends (including dividend on preference shares) covered under sub-clause (a), (b), (c), (d) and (e) of Section 2(22), illustratively covering –

- Distribution of accumulated profits, entailing the release of company's assets
- Distribution of debentures, deposit certificates to shareholders and bonus shares to preference shareholders
- Distribution on liquidation to the extent attributable to accumulated profits
- Distribution on the reduction of capital
- Advance or loan by a closely held company to its shareholder

WITHHOLDING TAX ON DIVIDEND PAYMENT TO RESIDENT SHAREHOLDER BY COMPANIES

Company making payment of dividend to resident shareholders has to deduct TDS under section 194 of the Income Tax Act 1961, (Act) at 10%. However, in case of resident individuals, no tax shall be withheld if the aggregate dividend distributed (in any mode other than cash) by Company during the Financial Year (FY) does not exceed INR 5,000. Due to ongoing pandemic, ***CBDT has reduced the rate of withholding from 10% to 7.5% for the period 14th May 2020 to 31st March 2021***.

If a resident shareholder fails to submit his PAN to the company, TDS would be deducted at a higher rate of 20% as per section 206AA of the Act. If the shares are held in Demat form, the PAN needs to be updated with the Depository. If the shares are held in physical form, the PAN needs to be updated with the Company's Registrar and Transfer Agents.

TDS will not be deducted in cases where a shareholder provides Form 15G /Form 15H provided the eligibility conditions are satisfied. Also, no tax shall be deducted in case of specified insurance companies, mutual fund specified under Section 10(23D) and Alternative Investment Fund whose income is exempt u/s 10(23FBA).

WITHHOLDING TAX ON DIVIDEND PAYMENT TO NON-RESIDENT SHAREHOLDERS BY COMPANIES

In cases where the dividends are paid to non-resident shareholders (other than FPI), tax is required to be deducted under Section 195 of the Act at 20% (plus applicable surcharge and cess). In case of Individuals/HUFs/AOP/BOI, the maximum applicable surcharge shall be capped at 15%.

Non Resident Shareholders can avail beneficial rate provided in the Double Tax Avoidance Agreement (DTAA) entered between India and the country of tax residence under section 90 of the Act.

In case of dividend paid to Foreign Institutional Investor/Foreign Portfolio (FII/FPI), tax has to be deducted under Section 196 @ 20% plus applicable surcharge and cess without providing for Treaty benefit at the time of withholding. There is no relaxation available for capping surcharge in case of FPI's structured as Trust.

APPLICABILITY OF TAX TREATY BENEFITS

The availability of tax treaty benefits to non-resident shareholders is subject to the satisfaction of several anti-abuse provisions such as:

- ✓ Qualifies as 'person' as per DTAA and eligible to claim DTAA benefits
- ✓ The recipient must be a 'beneficial owner' of the dividends in order to be eligible for a lower withholding rate under DTAA.
- ✓ Satisfaction of Principal Purpose Test (PPT) pursuant to Multilateral Instrument (MLI) (wherever applicable)
- ✓ Shareholder does not have a Permanent Establishment (PE)/Fixed base/Business Connection or POEM in India and in any case, the dividend income earned is not attributable to PE/Fixed Base/Business Connection.

PRINCIPAL PURPOSE TEST (PPT)

Globally, Base Erosion and Profit Shifting (BEPS) project had been initiated with the participation of about 135 countries and jurisdictions to tackle tax avoidance and ensure transparent tax environment. One of the outcomes of the said project is the introduction of Multilateral Instrument (MLI) which seeks to include tax treaty-related measures of the BEPS Project including Principal Purpose Test in existing DTAA without the need to negotiate every DTAA separately.

Under the PPT, the tax authority may deny tax benefits if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining benefit under tax treaty was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless such benefit is in accordance with the object and purpose of the treaty. The objective for introduction of PPT is to deny DTAA benefits in case of Treaty Shopping arrangements.

PPT would apply to tax treaty once introduced through MLI or bilateral negotiations. The satisfaction of PPT is perhaps one of the most challenging exercises due to its inherent subjectivity and absence of clear judicial guidance.

ARTICLE 8 OF MLI

Article 8 of MLI applies to certain tax treaties such as Canada, Slovenia, etc where concessional tax rate for dividend is applicable only if shareholder holds a certain minimum percentage of shareholding in a company for a minimum holding period of 365 days.

MOST FAVOURED NATION (MFN)

MFN clause in a treaty limits the taxation on dividends under the treaty to the extent of a more favourable tax rate or scope of taxation in another treaty. Indian treaties with Slovenia, Lithuania & Columbia provide for a favourable rate and can be considered for application of MFN.

WITHHOLDING TAXES AT A LOWER RATE

A shareholder can also approach the tax authorities for obtaining a lower withholding tax certificate under section 197 of the Act. In such a case TDS will be deducted at a rate mentioned in the withholding tax certificate.

PREREQUISITES FOR AVAILING TAX TREATY BENEFITS

For the purpose of availing Tax Treaty benefits, the Non-Resident shareholder should provide the following,

1. Self-attested copy of PAN card, if any, allotted by the Indian Tax Authorities.
2. Self-attested copy of Tax Residency Certificate (TRC) obtained from the tax authorities of the country of which the shareholder is resident.
3. Self-declaration in Form 10F, if all the details required in this form are not mentioned in the TRC.
4. Self-declaration by the non-resident shareholder as to:

   - Qualifies as 'person' as per DTAA and eligible to claim DTAA benefits based on the tax residential status of the shareholder, including having regard to the Principal Purpose Test (PPT) (if any), introduced in the applicable tax treaty with India;
   - No Permanent Establishment / Fixed base/Business Connection/POEM (Place of Effective Management) in India in accordance with the applicable tax treaty;
   - Shareholder is the beneficial owner of the dividend income to be received on the equity shares of the Company.
   - Not involved in any treaty shopping arrangement
   - Indemnity from Shareholder for tax demand including interest and penalty in case of any misrepresentation, inaccuracy or omission

The Company is not obligated to apply the beneficial DTAA rates at the time of tax deduction/withholding on dividend amounts. Application of beneficial DTAA rate shall depend upon the completeness and satisfactory review by the Company of the documents submitted by non-resident shareholders.

COMPLIANCE FOR COMPANIES PAYING DIVIDEND

Shift to the classical system of taxing dividends tremendously increases compliance burden on the company. For instance, a listed company may have tens of thousands of non-resident shareholders. Determining the tax residency of each shareholder and obtaining tax residency certificates as on the record date could be a mammoth exercise.

The company would also need to obtain appropriate declarations from the shareholders with respect to satisfaction of beneficial ownership test and the PPT criteria in order to determine appropriate TDS rate.

FILING FORM 15CA AND 15 CB

Company has to file Form 15CA for any payments made to non-resident irrespective of the amount. In addition to this company is also required to obtain a Chartered Accountant's certificate in Form 15CB if payments to a non-resident shareholder made during the year exceeds INR 5 Lakhs.

TDS RETURN AND TDS CERTIFICATE

Company will also be required to file TDS returns indicating tax withheld on payment of the dividend to shareholder and issue TDS Certificates.

WAY FORWARD

Shift to classical system and withholding tax on dividend under the new regime will allow the non-resident shareholders in most of the cases to claim credit of tax withheld on their dividend income in their home country due to the shift in incidence of tax from the company to the shareholder. However, the company paying dividend are saddled with additional tax and compliance burden which if not done appropriately or in time could result in additional costs for interest, penalties etc. Hence, companies should adopt a conservative approach while determining the appropriate rate of TDS on dividend payments.

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