Dividend, Interest, Capital Gains
- A Tax Treaty Perspective

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Today’s Discussion

- Investment income streams
  - Article 10 (Dividend), 11 (interest) and 12 (royalty) deal with the taxation of the earnings of capital invested. [Article 12 will be discussed in a separate session]
  - Jurisdictional sharing on taxing rights
  - Dividend Income
  - Interest Income

- Capital Gains

Base Convention: UN Model
Jurisdictions have adopted a sharing of taxing rights when it comes to investment income streams

- Resident state’s contention: capital originates from its jurisdiction
- Source state’s contention: it makes available its infrastructure, labour force, etc
- Trigger’s conflict particularly in case of capital borrowing states who cannot afford to forgo tax on income streams accruing to the non-residents
Treaty Principles

- Taxation in resident country (State R)
  - ‘State R’ is the country of which the person earning the income is a resident
  - Typically a treaty would not limit the rights of the “resident country” to tax income of its resident. It would acknowledge the taxability in source jurisdiction and provide for avoidance of double taxation (tax credits)

- Taxation in source country (State S)
  - ‘State S’ is the country in which the income arises or is sourced

- No exclusivity for taxation of dividends/interest under the UN Model
  - Primary rights to State R and limited rights to State S
  - The term “may be taxed” is adopted to represent that there is no exclusivity to any jurisdiction to tax

- It is the domestic laws of the respective countries that determine the final tax computation and compliances
Article 10: Paragraph 1

- **Dividends** paid by a company which is a **resident** of a State S to a resident of State R **may be taxed** in State R

- Treaty would not apply in following situations
  - Dividends paid by a company which is a resident of a third country
  - Dividends paid by a company resident of State R, and attributable to a PE in State S of an enterprise of State R
The term “dividend” has a broad definition and generally partakes the characterization as defined in the tax laws of the source state (discussed in subsequent slide).

The term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;

“Paid” should be construed in a wide manner – “Legally available to the shareholders”

> Not restricted to physical payment

Resident : Article 4
Article 10: (Case study 1)

- Article 10(1) will not apply since dividend not declared by a company resident of State S.
Article 10: Paragraph 2 & 4

- Source state may also tax such income. However, treaty provides for a threshold limit (to be agreed by member states).
  - Tax rate applies on the gross amount
  - Recipient must be a beneficial owner
  - Intermediary entities may not be eligible for concessionary rate if they are not beneficial owners
  - Anti-avoidance measure - ‘Substance over form’
  - Business holdings have a lower rate as compared to portfolio holdings
    - Capital/Voting power
    - Period of holding
    - Most India treaties 15%/10% rate on gross amount

- If dividends are effectively connected to a permanent establishment (PE) of enterprise “R” in State S, then income taxable in hands of “R” taxable as Business Profits (Article 7 or 14)
Article 10: (Case Study 2)

- Article 10(4) will apply
- State S can tax the same as ‘Business Profits’
Article 10: Paragraph 3

The term Dividends is defined to include:

- income from shares, “jouissance” shares or rights, mining shares, founders’ shares,
- other rights, not being debt claims, participating in profits; and
- other corporate rights which are subjected to the same taxation treatment as income from shares by the laws of the source state (State S) e.g. deemed dividend under section 2(22)
Article 10: Paragraph 5

Prohibits extra-territorial taxation (para 5)

A jurisdiction (say State R) cannot tax a dividend income merely because the profits originated from a taxable presence in its jurisdiction; unless

- The shareholder is a resident of that jurisdiction
- The holding in the company is attributable to such presence
State S does not have a right to tax the dividend income or any undistributed profits unless the holding is effectively connected to the PE [treaty applied State R and State S]  
State X will apply WHT based on treaty between State X and State R
Article 10: Additional Comments

- Dividend declared by an Indian company exempt from tax in the hands of the shareholder as per domestic law.
  - Thus, Paragraph 2 not relevant in cases of India as source state
  - Does this clause cover the dividend distribution tax?

- Treaty lower rates need not necessarily mean lower global effective tax
  - Indian resident company (IndCo) receives dividend from a Company resident in State S; liable to tax in India at 33.99% with a credit for the withholding taxes payable in State S
  - Credit in India will be restricted to 33.99% on the net dividend income
  - Global effective tax cost will be 33.99% on net or WHT in State S - whichever is higher
    - Underlying tax credits and tax sparing could change the result
Interest
Article 11: Paragraph 1 & 2

- **Interest arising** in “State S” and paid to a resident of “State R” may be taxed in State R

- Source state may also tax this income subject to the threshold rate agreed in the treaty
  > Para 2 similar to Dividends Article

- **Additional comments:**
  > Recipient must be a beneficial owner of the interest for the concessionary rate
  > Select treaties exempt in State S the interest derived and beneficially owned by the Government or local authority of State R; or in some treaties based on specified institutions/associations/schemes
Article 10: (Case Study 4)

- State S to apply concessionary rate as treaty with State R
Article 11: Paragraph 3

- Interest has a broad and exhaustive definition and includes typically all forms of interest
  - However it does not draw reference to the domestic law and is a self-code
  - Definition under US model convention broader and draws reference to domestic law. Please note not present in India-US treaty

- Interest contractually charged for delayed payments is in relation to a debt claim and will qualify as interest income
  - Some treaties specifically provide for the words “including interest on deferred payment of sale”
  - Amounts included in lump-sum purchase price (notional interest or opportunity cost included in transaction value) will not qualify as interest income
Article 11: Paragraph 3

- Premium on redemption of debentures has been considered as Interest in Model Convention commentary. However domestic law and precedents have held that it constitutes capital gains.
- Some streams not to be considered as interest income are:
  > Penal charges for late payment
  > Items of income dealt with in Article 10
  > Profit/loss on sale of debentures/bonds
- “Net of tax” interest where borrowers need to bear the withholding tax – the withholding tax is an additional interest to the lender.
Net basis of taxation (under Article 7 or 14) shall apply where:

- Beneficial owner (who is a resident of State R) carries on business in State S through a PE or fixed base; and
- the debt claim for which interest is paid is effectively connected to the PE or fixed base or business activities referred to in Article 7(1)(c) {Force of attraction}
- Applicability of Section 115A under the Act?
Company A resident in India purchases goods from a foreign company B (say UK). It requires to contractually pay an interest for a credit period of 60 days. Does Company B have a tax incidence in India?

> Nature of contract and intent of parties need consideration

Assume Company B has a branch office in India through which the goods are supplied. Would the consequence change?
Article 11: Paragraph 5 and 6

- Interest is deemed to arise in a country [paragraph 5]
  - if the payer is a resident of that country
    - Even if the debt is utilised outside the country (in such situation domestic law could be favourable)
  - or the interest is attributable and borne by a PE in that country
    - The indebtedness for which the interest is paid is incurred in connection with the PE

- This Article applies only to the arm’s length interest amount
  - Treatment of excess interest as per domestic law
    - Needs consideration: Is it interest, a constructive dividend or other income?
Remarks: Dividend and Interest

- **Beneficial Ownership**
  - Not defined and so triggers complexities

- **Permanent Establishment Proviso**
  - Attribution issues
  - Domestic law interplays

- **Procedure for reducing tax at the source**
  - Withholding as per treaty rate; or
  - Withholding as per higher rate and then claiming refund
  - Timing of the withholding to ensure credit in State R
  - Documentation
  - Does surcharge need to be added to the treaty rate?

- **Characterisation of income as dividend or interest?**
  - Source state tax implication
  - Eligibility to credit in Resident State
Capital Gains
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

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
Applies to all kinds of capital gains. However does not deal with differences on how to and what to tax as capital gains.

- Left open to the domestic law of each state
- By itself does not give any right to the state to tax the capital gains if not provided in the domestic law

Principles underlying the sharing of rights

- No distinction is made between the capital gains or business profit
- Right to tax the capital gains on the property is given to the state which is entitled to tax the income from that property
- Right to tax the gains from alienation of the business assets is generally given to the same state which taxes the business profits
Scope of Article 13

- Resident country continues to have the right to tax all capital gains
- Gains from, alienation of immovable property (para 1) may be taxed in the country in which it is situated
  > Meaning of immovable property: Article 6
- Gains from the alienation of shares of a company or of an interest in a partnership, trust or estate, the property of which consists primarily of immovable property (para 4), may be taxed in the country in which the property is situated
  > Source state cannot tax income from shares of such a company if the immovable property used for business activities
Scope of Article 13

- [Para 2] Gains on alienation of moveable property (alone or with the whole enterprise) forming part of a PE or fixed base, may be taxed in the Source country
  - Term moveable property not defined
  - General Clauses Act, 1897 provides that it means all property other than immoveable property
  - Intangible property likely to qualify as moveable property
  - Source country could tax a capital gains irrespective of whether a PE exists at the time of alienation

- [Para 3] Gains from alienation of ships or aircrafts, boats engaged in inland waterways transport or moveable property pertaining to these shall be taxable only in the country in which the place of effective management of the enterprise is situated [refer Article 8]
Scope of Article 13

- [Para 5] Gains from alienation of shares (other than those referred earlier i.e. immovable property company) representing a certain percentage of holding can be taxed in the source country provided the company whose shares are alienated is a resident of the Source Country.

- [Catch-all clause Para 6] Capital gains arising from property other than those referred above will be taxable in the resident country only.
Additional Points

- Alienation and capital gains not defined in the article
  - Depends on the domestic law
    - Will it be resident country or source country?
  - “Alienation” to draw parallel from the term “transfer”
  - Capital Gains defined in domestic law to include long-term, short-term and gains due to depreciation of national currency

- Article 13 deals only with taxation in the State of source. To what extent the State of residence should take account of taxation allowed under the treaty and imposed by the State of source, is government by Article 23.

- Select treaties of India (e.g. US, UK) merely provide that the capital gains will be taxed in accordance with the domestic law of the respective countries
Remarks

- The varying laws on capital gains between jurisdiction provides
  - Opportunity for tax planning
  - Risk of double taxation

- Country specific analysis is a must prior to concluding.
Thank You

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The information provided in this presentation is generic in nature and needs case-specific revalidation before being adopted for decision making.