case study: tax credit for dividend distribution tax in the hands of the U.S. parent

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History repeats itself. The Finance Act, 1997 introduced a new chapter XII-D in the Income-tax Act, 1961, ("the Act"). It brought to charge the profits distributed by domestic companies at a rate of 10 per cent. Such tax was levied in respect of dividends declared, distributed or paid by domestic companies on or after June 1, 1977 but before March 31, 2002. Once again, the provisions of this section have been revived. Section 115-O (1) of the Act stands substituted, by the Finance Bill, 2003, (which is awaiting presidential assent), to read as follows: "*Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2003 whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of twelve and one-half per cent*".

As per section 115-O (3) tax on distributed profits of domestic companies or "dividend distribution tax" is to be paid to the government treasury within 14 days from the date of declaration of dividend; or distribution of dividend; or payment of any dividend whichever is earliest.

This is not a withholding tax on the dividends distributed to the shareholders. It is a secondary tax on corporate profits distributed. The tax is levied on the post tax income of the domestic company, from which the dividend is declared/distributed by it. As it is not in the nature of a withholding tax, the issue that arises is whether a foreign parent, will get a credit for the dividend distribution tax borne by its Indian subsidiary company. This issue needs to be examined under the provisions of the relevant double tax avoidance agreement ("DTAA"), if any, the provisions of the Act and the domestic tax regulations of the country of which the foreign parent is resident.

Case study:

Perhaps in the context of the Silicon Valley of India, Bangalore, it is useful to examine a scenario wherein the parent of the Indian subsidiary is a tax resident of the United States ("U.S."). ABC Inc, a U.S. resident, holds 99.99 per cent in ABC Pvt Ltd, a domestic company. What would be the tax implications arising out of the provisions of section 115-O, in the hands of ABC Inc?

Analysis of the provisions of the Indo-US DTAA:

Article 25(1) of the Indo-US DTAA that deals with elimination of double taxation provides that the U.S. shall allow to a resident or citizen of the United States as a credit against the U.S. tax on income:

(a) the income-tax paid to India by or on behalf of such citizen or resident; and

(b) in the case of a U.S. company owning at least 10 per cent of the voting stock of a company which is a resident of India and from which the U.S. company receives dividends, the income-tax paid to India by or on behalf

of the distributing company with respect to the profits out of which the dividends are paid.

Article 2 stipulates what shall be regarded as "income-tax" for DTAA purposes. Article 2(1)(b) refers to the Indian tax as including: (i) the income-tax including any surcharge thereon, but excluding income-tax on undistributed profits of companies, *imposed* under the Income-tax Act; and (ii) the surtax. Penalties paid for any default or omission in the payment of the above-mentioned taxes is not covered by the term "taxes" under the Indo-US DTAA. It needs to be examined whether dividend distribution tax, partakes the nature of income tax under the Act, as is referred to in the relevant provisions of the Indo-US DTAA..

Analysis of the provisions of the Act:

Section 115-O refers to the dividend distribution tax as "additional income-tax". As mentioned earlier, such tax is not in the nature of withholding tax, but is a levy on the post tax profits of the company out of which the dividend is declared or distributed.

Article 2(1)(b) of the Indo-US DTAA excludes from the scope of Indian tax, any tax on the undistributed profits of companies imposed under the Act. The tax referred to in section 115-O does not meet this criterion. This argument gains support from the language used in sub section 4 of section 115-O(4) of the Act, which states: "*the tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends...*"

Thus, it is clear that the dividend distribution tax is an income-tax on the distributable profits of the domestic company and it falls within the definition of Indian taxes as envisaged under Article 25 read with Article 2(1)(b) of the Indo-US DTAA. Hence, the parent company should be eligible for a tax credit as per DTAA provisions.

Domestic tax laws in the U.S.:

The relevant provisions in this regard, are sections 901 and 902 of the Internal Revenue Code ("IRC"). Section 902, also referred to as the indirect foreign tax credit rule, states that a U.S. domestic corporation that owns 10 per cent or more of a foreign corporation from which it receives dividends in any taxable year is deemed to have paid the foreign taxes imposed on, and paid by, the foreign corporation in the same proportion of such foreign corporation's post-1986 foreign income taxes as the amount of such dividends bears to such foreign corporation's post-1986 undistributed earnings.

Let us assume that ABC Pvt Ltd, has a net profit of USD 100 and it pays a tax of USD10. It distributes USD 50 to ABC Inc. As per section 902, ABC Inc is deemed to have paid USD 5 out of the USD 10 of foreign tax paid by its Indian subsidiary, and it would accordingly be entitled to a foreign tax credit to this extent.

The next issue that arises is whether the dividend distribution tax borne by ABC Pvt Ltd can be regarded as a foreign "income tax" under the U.S. tax laws. If yes, then this tax will be creditable in the hands of ABC Inc, in the manner described above. For such analysis, we have to examine, section 901 of the IRC. It defines an income-tax for U.S. tax purposes as one that is **both compulsory and imposed** on net income and gains. As brought out by the preceding discussions, the dividend distribution tax borne by ABC Pvt Ltd, satisfies both these conditions and would be regarded as "income tax" under the domestic tax law of the U.S.

Conclusion: Dividend distribution tax would fall within the definition of "income-tax" under the domestic tax laws of India. Such tax would qualify for the underlying tax credit under Article 25 read with Article 2(1)(b) of the Indo-US DTAA.

Further, such tax also qualifies as foreign income tax under the IRC. It may be useful to note that the U.S. adopts a liberal interpretation of treaties to give effect to the apparent intentions of the contracting parties. Although the U.S. has not ratified the Vinenna Convention it generally accepts its principles.

As can be seen from the above analysis, the ABC Inc would be able to claim a tax credit for the additional dividend distribution tax borne by its ABC Pvt Ltd. ❏