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Tax on dividends distributed by Foreign Subsidiaries – An Amnesty Scheme?

'Dividend' is derived from the late 15th century Latin word *dividendum,* which literally means "thing to be divided". It was only in the 17th century that the word got its modern sense as a "portion of interest on a loan, stock, etc." Today, this meaning of 'Dividend' is understood by one and all. However, views on its taxability remain '*divided*' even today!

1. Divided we 'tax':

1.1 Dividend tax has always been a controversial issue. The concept that a shareholder has to pay tax on the same profits which are already taxed in the hands of the company, at first glance, defies logic. However, technically the shareholder and the company are two separate assessees. Hence profits earned by the company are taxed in the company's hands and taxed again when divided amongst/distributed to the shareholders. To avoid the administrative hassle of taxing dividend and granting refunds to individual share holders, the dividend distribution tax (DDT) model has been in place for quite some time in India. DDT is payable by the company before remitting dividends to its shareholders. To lower the double-taxation impact, DDT is levied at 15 per cent instead of the full rate of tax and dividends are thereafter exempt in the hands of the shareholders.

1.2 DDT has led to a cascading effect on taxes on dividends, especially when there is a chain of subsidiary companies, one below the other. Therefore, in India, a flat corporate structure is preferable over a more vertical one.

2. Rationale for relief:

2.1 The cascading tax effect is further exacerbated in the case of foreign subsidiaries. Profits remitted by Multi-national corporations (MNCs) as dividends from their foreign subsidiaries are subjected to the full rate of 30 per cent tax as per the current tax provisions, while domestic dividends are taxed at 15 per cent. Therefore, these profits were generally held outside and not brought back into India.

2.2 For quite a few years, Indian MNCs were lobbying for a lower tax on such foreign dividends. The Finance Minister in his Budget speech has also referred to the disincentive caused to these MNCs due to the high rate of tax to be paid for repatriation of foreign dividends into India. It seems the Finance Ministry has finally relented by introducing a new section through the Finance Bill 2011. Section 115BBD has been proposed for providing a lower rate of 15 per cent tax on dividends earned by Indian companies from their foreign subsidiaries.

2.3 A simple illustration will give a comparison between the amount of profits foregone as taxes under the existing provisions and under the proposed provisions:

For example, an Indian company has a subsidiary in China. The total tax on profits earned by the Chinese subsidiary when distributed as dividend to the Indian Holding company would be to the tune of 51 per cent as can be seen from the table below. With the introduction of Section 115BBD, the tax impact will now be lower, as shown in the corresponding columns in the table below:

Sr. No.	Particulars	As per current law		As per new provision	
		Income (Rs.)	Tax (Rs.)	Income (Rs.)	Tax (Rs.)
1.	Profits earned by Chinese subsidiary	1,000		1,000	
2.	Chinese Tax on Corporate profits (assumed @ 30%)		300		300
3.	Profit after tax	700		700	
4.	Dividend distributed (assumed @ 100%)	700		700	
5.	Dividend tax paid in China (assumed @ 10%)		70		70
6.	Dividend earned by Indian holding company	700		700	
7.	Tax on dividend in India @ 30%/ 15% (after 1st April 2011)		210		105
8.	Less: credit for dividend tax paid in China		(70)		(70)
9.	**Total tax (2 + 5 + 7 + 8)**		**510**		**405**
10.	Net dividend after tax	490		595	

Therefore, with the new provision, the effective tax rate on dividend would get lowered from 51 per cent to 40.5 per cent. Corporates which have had their profits lying unused outside India may now start bringing this money into India.

However, as is the norm with application of tax provisions, there are more than one tax effects.

3. Two sides of the same coin - Amnesty Scheme:

3.1 There is a positive impact with the introduction of this relief provision. But there are also a couple of negative unintended consequences as described below.

3.2 Effective use of this new provision could open the flood gates to black money coming back in to India! In the past, tax evaders have been hesitant to pay tax on their incomes. However, with the effective implementation of computerised records available with the tax department, many profitable modes of investments are possible only if the funds are white money/disclosed wealth. Because of this, holding black money has a higher opportunity cost.

3.3 Indians earning profits outside India may at present route these profits into India by the use of tax havens. Through various manners, the money would be brought back in the form of capital or loans.

3.4 The problems that these coporates presently face are: the FEMA compliance and KYC requirements; sectoral restrictions for infusion of capital (FDI regulations); restrictions on availing foreign loans under the FEMA regulations; and the transfer pricing regulations under the Income-tax Act.

3.5 This is precisely the reason that many tax evaders may now be comfortable to make use of the new provision for bringing their unaccounted foreign income back into the system in the form of dividends. The problems faced in routing their money as capital and loans may not be faced when bringing in dividends. Further, these would be brought in with a payment of just 15 per cent tax.

4. The modus operandi:

4.1 But the pressing question is how can a tax evader resort to this provision for converting his black money into white?

Here again, the simplest manner is to route unaccounted money through a tax haven. The effective tax rate on dividends would be very low as the tax haven subsidiary would not be liable to corporate tax on its profits or withholding tax on dividends.

4.2 For example, Company A in India earns substantial profits from its overseas operations, which are not disclosed in its tax returns in India. It wants to get these profits back into India. Company A opens a subsidiary, Company B, outside India in a low or nil tax jurisdiction like Dubai. Company B would then build up paper profits through bogus trading transactions. Finally, Company B would remit these profits into India at a lower tax rate of 15 per cent.

The tax payable would be as per table below:

Sr. No.	Particulars	Subsidiary in Dubai	
		Income (Rs.)	**Tax (Rs.)**
1.	Profits earned by foreign subsidiary in a tax haven	1,000	
2.	Tax on Corporate profits		Nil
3.	Profit after tax	1000	
4.	Dividend distributed (assumed @ 100%)	1000	
5.	Dividend tax paid in the tax haven		Nil
6.	Dividend earned by Indian holding company	1,000	
7.	Tax on dividend in India @ 15%		150
8	**Total tax (2 + 5 + 7)**		**150**
9.	Net dividend after tax	850	

As can be seen from the above illustration, the total tax payable would be only 15 per cent!

4.3 This will become in effect an unofficial legal mode for converting unaccounted money into fully tax-paid money. A flood of such remittances may happen in the coming financial year because of this provision. This is the reason that this provision is dubbed as an Amnesty

scheme. And as is true with all amnesty schemes, the honest tax payers are at a gross disadvantage as the tax evaders get away with lower taxes and lesser scrutiny.

However, the intention of bringing in this provision is not to provide an Amnesty scheme. To avoid such unintended tax consequences, the Income-tax Department can use a few fire-fighting provisions it has up its sleeve.

5. Anti-tax avoidance measures:

5.1 The Income-tax Department has introduced in recent years more and more stringent anti-tax avoidance measures like Transfer Pricing. These specific anti-tax avoidance provisions are however restricted to actual commercial transactions or pricing. For example, loan and purchase transactions can be adjusted by a tax officer to compute the actual profits made by an assessee.

However, declaration of dividends is purely a management decision. As there is no pricing involved, transfer pricing provisions cannot be applied to dividends.

5.2 But a tax officer may apply Section 68 of the Income-tax Act. Section 68 applies to all items credited in the books of an assessee for which adequate explanation of its nature or source is not available with him. The tax officer can in such a case treat the credit as income of the assessee and bring it to tax.

5.3 Dividends earned by an Indian company would be credited in the books of a company. Further under the proposed provision, these dividends would be taxed at a lower rate of 15 per cent. Therefore, whereever circumstances are suspicious, a tax officer can inquire into the source of such dividends earned by the holding company under Section 68.

5.4 Section 68 gives discretion to the tax officer to ascertain whether the source and nature of a particular credit is satisfactorily explained by the tax payer or not. The decision would depend on facts of each case. It is more of a substance over form issue rather than a procedural disallowance.

5.5 In cases where the dividends are declared by subsidiaries with an actual business in a jurisdiction with proper taxes on income, Section 68 would not be applied. However, where these dividends are from a

subsidiary in a tax haven, with low or nil tax on corporate profits, a prima-facie case for scrutiny would arise.

5.6 For example, where dividends are declared by a Dubai subsidiary, the tax officer can inquire into the genuineness of the transaction. The tax officer can also check into the capability of the Dubai subsidiary to pay such dividends. Where the profits are declared from genuine business transactions conducted by the Dubai subsidiary, the tax officer would have to allow the taxation of dividends at the lower rate of tax. However, where it is apparent to the tax officer that the Dubai subsidiary has no genuine business, a strong case for disallowance of the relief provision is available to the tax officer.

5.7 There have been an umpteen number of judicial decisions on the extent to which a tax officer can enquire under Section 68. This mainly depends on the factual situation of each case. Therefore, though a tax evader may be able to bring back unaccounted money by using the proposed provision, litigation would be a certainty.

5.8 A provision which leads to litigation in most cases may not be a useful provision. Further, it may also be affected by arbitrary exercise of the tax officers' discretionary powers. To avoid such a situation, it would be better to have a proper solution in the form of a revised provision.

6. Underlying solution:

6.1 A balance needs to be achieved between (i) the need for bringing down the double taxation on dividends and (ii) possible use of the provision as a tool for laundering unaccounted money.

6.2 A possible solution could be worked out by introducing a unilateral domestic underlying tax credit mechanism for foreign dividends. When Underlying Tax Credit (UTC) is given, the share holder gets credit for corporate taxes paid by the company in addition to the credit on tax paid on dividend. Currently, Indian Income-tax Act does not provide for UTC. India has only a couple of double-taxation avoidance agreements which provide for UTC.

6.3 Under this mechanism, instead of taxing the foreign dividends at 15 per cent, these incomes should be taxed at the full rate of 30 per cent. But along with full tax, credit for taxes paid on the corporate profits from which the dividend is declared should be allowed. As is seen in the first table, due to foreign corporate taxes and withholding tax on dividend, a significant amount of taxes are already paid in the foreign country. Therefore, if due credit is given against these taxes, the cascading impact

of tax on bringing dividends into India would be mitigated. This would essentially resolve the double-taxation issue for dividends.

6.4 At the same time, dividends declared from tax havens would have suffered a very low or nil tax on the corporate profits. These dividends would not escape the Indian tax of 30 per cent as credit would be available for only those taxes which are actually paid.

6.5 This can be better explained with the help of a simple illustration as under:

In our examples above, if instead of a 15 per cent tax on dividends, a full rate of 30 per cent tax is levied along with full credit for UTC, the tax impact would be:

Sr. No.	**Particulars**	**Subsidiary in China**		**Subsidiary in Dubai**	
		Income (Rs.)	**Tax (Rs.)**	**Income (Rs.)**	**Tax (Rs.)**
1.	Profits earned by foreign subsidiary	1,000		1,000	
2.	Tax on Corporate profits (assumed @ 30% / 0%)		300		Nil
3.	Profit after tax	700		1,000	
4.	Dividend distributed (assumed @ 100%)	700		1,000	
5.	Dividend tax paid (assumed @ 10% / 0%)		70		Nil
6.	Dividend earned by Indian holding company	700		1,000	
7.	Proportionate taxable income in the hands of Indian shareholder	1,000		1,000	
8.	Tax on income in India @ 30%		300		300
9.	Less: Credit for underlying taxes paid restricted to amount of tax		(300)		Nil
10.	**Total tax (2 + 5 + 8 + 9)**		**370**		**300**
11.	Net dividend after tax	630		700	

Total tax outgo under such a suggested provision would be limited to 37 per cent in genuine cases. In this manner, effective tax rate of 51 per cent as per the first illustration would be brought down to around 37 per cent.

Further, for those dividends which are declared from tax havens credit would be available only to the extent of actual taxes paid. Therefore, in cases where there is no tax outgo, full Indian tax of 30 per cent would be payable. This would be a deterrent for using the provision as a Tax Amnesty Scheme.

6.6 Underlying tax credit in true parlance would cover taxes paid by all the companies in a chain of subsidiaries. This would enable the tax payer to claim credit for taxes paid by the operational subsidiary.

For example, an Indian company is having a Dubai subsidiary which holds a Chinese operational company. In such a scenario, if underlying tax credit is allowed, tax paid on dividends in India would be set-off against the corporate taxes paid by the Chinese company. This can prove as a major relief for tax payers. And yet, the Indian company will get set off only for taxes paid.

6.7 There are certain economic arguments against this proposal. The tax department would not like to forego their taxes on dividends repatriated into India. However, a simple counter-argument against this is the fact that under the existing provisions they are in any case not earning optimum taxes. This is for the simple fact that most profits are not remitted into India at all! The suggested provision serves both as an incentive to genuine tax payers, while at the same time as a disincentive to tax evaders. It would also fulfill the prime objective of introduction of this provision of bringing in more funds into India.

6.8 Taking an overall perspective, to avoid the misuse of this provision, it would be in the interest of both the tax department and the tax payer to have a modified provision by introduction of an underlying tax credit mechanism.

7. Unfairly Taxed:

7.1 Another negative impact of the proposed Finance Bill provision is that a **foreign branch and subsidiary** would not be taxed at par.

7.2 For example, a Dubai branch of an Indian company would be levied a Nil corporate tax in Dubai. The same branch profits would be liable to a 30 per cent tax in India. The effective tax rate payable in India

after availing the double-taxation agreement would still be 30 per cent as credit for taxes paid in Dubai would be zero.

7.3 In contrast, a Dubai subsidiary would also pay taxes on its profits at the same Nil rate in Dubai. However, whatever profits are remitted into India as dividends would be taxed at 15 per cent and not 30 per cent as per Section 115BBD.

7.4 With this new provision, overseas subsidiaries would have a clear advantage over an overseas branch. This undue advantage can effectively be eliminated by the suggested provision of levying a dividend tax of 30 per cent along with underlying tax credit.

8. Conclusion:

As can be seen, a simple provision providing relief to tax payers can lead to unintended consequences! The tax department presently has only Section 68 to block tax evaders bringing their unaccounted money back through this route. A better way out would be to introduce a revised provision allowing underlying tax credits.

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