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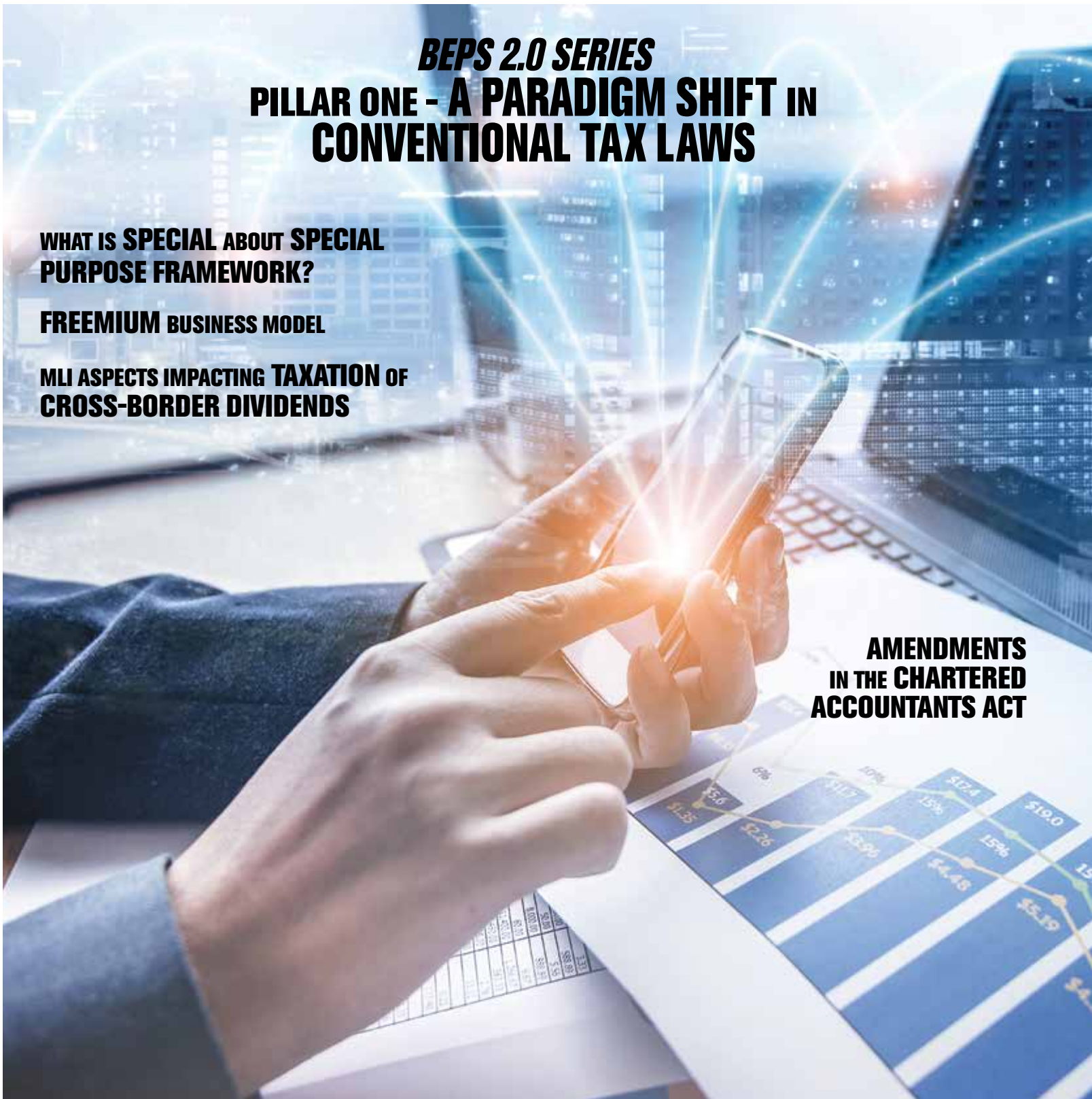

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MLI SERIES

MLI ASPECTS IMPACTING TAXATION OF CROSS-BORDER DIVIDENDS

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INTRODUCTION

The issues related to the taxability of dividends have always remained significant due to the **inherent two-level taxation** compared to other income streams like interest. Further, the taxing provisions are drafted in varied manners in an attempt to rein in any tax avoidance on such incomes. Taxation of dividends in the international tax arena has had its own set of complexities. In India, for a considerable period of time there used to be double taxation on foreign shareholders due to limited availability of credit for Dividend Distribution Tax (DDT) paid by Indian companies under the Income-tax Act. However, after the abolition of the DDT concept vide Finance Act 2020, **cross-border dividends are now taxable in the hands of non-resident shareholders - bringing up issues of beneficial ownership, classification, conduit arrangements, etc.**

This article concludes the series of articles for the **BCAJ** on Multi-lateral Instrument (MLI). The series of articles have explained the multilateral efforts to reduce tax avoidance and double non-taxation through MLI – a result of the Base Erosion and Profit Shifting (BEPS) Project of the G20 and OECD. MLI has acted as a single instrument agreed upon by a host of countries[1] through which several anti-abuse rules are brought in at one stroke in the DTAAs covered by the MLI.

Article 8 of the MLI provides anti-avoidance rules for **Dividend Transfer- Transactions**. This **article attempts to highlight how the MLI has affected cross-border taxation of dividends**, which has gained importance following the change in Income-tax Act from 1st April 2020. At the same time, **it does not deal with the cross-border or domestic law issues that affect dividend payments in general,** as it would be beyond the outlined scope of this article.

1 99 countries as on 10th May, 2022

TAXABILITY OF DIVIDENDS UNDER TREATIES

Under the double tax avoidance agreements (DTAAs), as far as tax revenue sharing is concerned between the two countries entering into the agreement, specific caps are prescribed for passive incomes like dividends, interest, royalty and fees for technical services. As per Article 10 of the OECD and UN model conventions, while the Country of Residence (COR) is allowed the right to tax dividends, the Country of Source (COS) is also allocated a right to tax such dividends. For dividend incomes, the COR is the country where the recipient of dividends is a resident; and the COS is the country where the company paying dividends is a resident of.

However, there is a cap on the tax which can be levied by the COS under its domestic laws, if the Beneficial Owner (BO) of such dividends is a resident of the other contracting state (i.e., COR). While typically, this cap is set at around 20-25% in DTAAs, a concessional rate of around 5-15% is prescribed if the BO is a company which meets the **prescribed threshold of holding a certain minimum shareholding** in the company paying dividends. This is considered to be a relief measure for cross-border corporate ownership structures, as against third-party portfolio investors who would generally hold a much lesser stake in the company paying dividends. The relief is explained below through an illustration:

Illustration 1: C Co., a Canadian Co., owns 12% voting power in I Co., an Indian Co. I Co. declares a dividend. The applicable dividend provisions of the India-Canada DTAA are as under:

Article 10
1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the

Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the recipient is the beneficial owner of the dividends the tax so charged shall not exceed:

(a) **15 per cent** of the gross amount of the dividends if the beneficial owner is a company which controls directly or indirectly **at least 10 per cent** of the voting power in the company paying the dividends;

(b) **25 per cent** of the gross amount of the dividends in all other cases.

As can be seen from the above, Article 10(2)(b) of the India-Canada DTAA provides for a cap of 25% on tax leviable in India (the COS in this case). However, as C Co., the beneficial owner of dividends from I Co., owns at least 10% voting power in I Co., the condition for minimum shareholding as specified for concessional rate in Article 10(2)(a) is met. Thus, the cap of 25% stands reduced to 15% as per Article 10(2)(a) of the India-Canada DTAA. This is the relief which is sought by group companies receiving dividend incomes on their investments in Indian companies.

PRONE TO ABUSE

The above reduced tax rate has led to abuse of this provision in cases where companies try to take benefit of the concessional rate by meeting the threshold requirement only for the period that the dividend is received. A simple illustration for understanding how this provision is abused is as follows:

Illustration 2: Continuing our example above, Con Co., a Canadian group Co. of C Co., also owns a 9% share capital of I Co. This holding would not allow for the concessional rate of tax to be applied when I Co. pays dividends to Con Co. However, just before the declaration of dividend by I Co., Con Co. buys an additional 1% stake in I Co. from its group Company C Co., which, as explained above, already holds a 12% stake in I Co. After this transaction C Co. continues to hold 11% stake in I Co.; while Con Co. will now hold 10% stake in I Co. As both Con Co. and C Co. now hold 10% or more in I Co., they fulfil the threshold requirement under Article 10(2)(b), and the concessional tax rate of 15% is applied. As this transaction is done only to avail the concessional rate, as soon as the dividend is distributed, the additional 1% holding is transferred back by Con Co. to C Co.

In this manner, by complying with the threshold requirement in a technical sense, Con Co. avails of the concessional tax rate. This is possible as the India-Canada DTAA does not provide for a minimum period for which the prescribed threshold for shareholding of 10% is required to be held for. This means that even if Con Co. meets the threshold for just the day when it receives the dividend from I Co., even then it can avail the concessional rate.

The Report on BEPS Action Plan 6 had identified this abuse and provided a possible solution to counter it by prescribing a threshold period for which shareholding is required to be held. This solution has been enacted in the form of **Article 8 of the MLI – "Dividend Transfer Adjustments",** which is explained below.

STRUCTURE AND WORKING OF ARTICLE 8 OF THE MLI

Article 8 of the MLI provides that the concessional rate shall be available **only if** the threshold for minimum shareholding is met for **a period of 365 days** which includes the day of dividend payment. It should be noted that while Article 10 of the DTAA covers all recipients of dividends, the concessionary rate is available only to **companies**. Thus, the new test as per Article 8 of MLI also applies only to companies. At the same, time relief has been provided for ownership changes due to corporate re-organisation. [Para 1]

This condition shall apply **in place of or in the absence of** the minimum holding period condition existing in the DTAA. [Para 2] Thus, wherever Article 8 of the MLI applies, the new test of a 365-day holding period would be applied in the following manner:

• Where the treaty already contains a holding period test– such period would get replaced with the 365-day test; or

• In case of treaties where no such test exists, such a test would be introduced.

However, it should be noted that **Article 8 of the MLI is an optional anti-abuse provision of the MLI.** It is not a mandatory provision. Thus, the **new minimum holding period test applies only to treaties where both the contracting states (countries party to the treaty) not only agree to the applicability of Article 8, but also to the manner in which it is applicable.** The following options are available to the countries with regard to the applicability of Article 8:

• Para 3(a) provides that a country may opt out entirely

from this new test; or

• Para 3(b) provides that a country may opt out to the extent the DTAA already provides for:

i. A Minimum Holding Period; or

ii. Minimum Holding Period shorter than 365 days; or

iii. Minimum Holding Period longer than 365 days.

Each country has to list which option it would be exercising from the above. Further, it also has to list down the DTAAs to which the above provision may not apply. Thus, India has opted out of Article 8 by way of reservation under Para 3(b)(iii) covering the India-Portugal DTAA as the treaty provides for a threshold period of 2 years already, which is higher than the one proposed under Article 8 of the MLI. Hence, the existing condition of 2 years will continue to apply in India-Portugal DTAA irrespective of India signing the MLI.

Para 4 states that countries shall notify the DTAA provision unless they have made any reservation. When two countries notify the same provision, only then will the 365-day threshold apply. India has notified such provision in its DTAAs with 24 countries. However, not all of these 24 countries have corresponded similarly. Hence, Article 8 of the MLI applies if the corresponding country has also notified its treaty with India under the same provision. A couple of illustrations will show how Article 8 of MLI works:

Illustration 3: Both India and Singapore have notified India-Singapore DTAA as a Covered Tax Agreement which will get impacted by MLI. India has notified the treaty under Article 8(4) of MLI. Basically, India agrees to apply the new 365-day test to the treaty. The India-Singapore treaty presently does not provide for such a test. However, Singapore has reserved the right for the entirety of Article 8 not to apply to its Covered Tax Agreements [Para 3(a)]. Hence, while India has opted for applying MLI Article 8, Singapore has not. Thus, the Dividend Article of India-Singapore DTAA will not be affected by Article 8 of MLI even though India has expressed its willingness for the same.

Now let us consider another illustration:

Illustration 4: India and Canada both have made a notification under Article 8(4). No reservation has been made by any country for the relevant provision. Thus, there is no mismatch and Article 8 of MLI applies to the India-Canada DTAA. While before the MLI, there was no holding period requirement under the India-Canada DTAA, on the application of the MLI, the 365-day holding period gets inserted in the DTAA.

Considering the above, the following is the list of Indian treaties which have been amended by Article 8 of the MLI as both India, and the corresponding country have agreed to the applicability of Article 8 in the same manner, along with the respective dates for entry into effect of the MLI:

Country	Threshold period for shareholding (pre-MLI)	Threshold period for shareholding (post-MLI)	Entry into Effect in India for TDS	Entry into Effect in India for other taxes
Canada	Nil	365 days	1st April, 2020	1st April, 2021
Denmark	Nil	365 days	1st April, 2020	1st April, 2021
Serbia	Nil	365 days	1st April, 2020	1st April, 2020
Slovak Republic	Nil	365 days	1st April, 2020	1st April, 2020
Slovenia	Nil	365 days	1st April, 2020	1st April, 2020

The above treaties already had specific thresholds for applicability of the concessional rates which are provided below for ease of reference:

Country	Condition for minimum shareholding / voting power	Concessional rate if condition is met	Tax rate if condition is not met
Canada	10%	15%	25%
Denmark	15%	15%	25%
Serbia	25%	5%	15%
Slovak Republic	25%	15%	25%
Slovenia	10%	5%	15%

The illustration below will explain the changes pre and post MLI.

Illustration 5: SE Co., Serbia owns 21% shares of IN Co., India. On 1st April, 2021, SE Co. buys an additional 4% stake in IN Co. from a group company. IN Co. declares and pays a dividend on 15th December, 2021. SE Co. exits its stake of 4% on 1st January 2022. Pre-MLI, India-Serbia DTAA provided for a concessional tax rate of 5% where a minimum holding of 25% was met, even if such stake was held for only the day when dividend was earned. However, that has changed post-MLI. Post MLI, Article 10 of the India-Serbia treaty, as modified by Article 8 of MLI, provides that the concessional tax rate will be available only if the condition for a minimum holding period of 365 days is met. As that would not be met in this case, the concessional rate of tax on dividend income would not be available to SE Co.

365-DAY TEST

As per the MLI provisions, the recipient company shall hold the prescribed percentage of share capital for a period of 365 days to avail the concessional rate. The exact provision that gets added to the Dividend Article of the above-mentioned DTAAs is as follows:

[*Subparagraph of the Agreement dealing with concessional rate*] shall apply only if the ownership conditions described in those provisions are met throughout a 365 day period that includes the day of the payment of the dividends…

As can be seen above, the 365-day period would include the date of payment of the dividend. Thus, the language entails a **"Straddle Holding Period"** – a period covering the dividend payment date – but extending before or after such date. An illustration for the same is as follows:

Illustration 6: Continuing from Illustration 5 above, let us consider a case where SE Co. of Serbia continues to hold its stake of 25% in IN Co., India, for the foreseeable future after acquiring the 4% stake on 1st April, 2021. In such a case, even though the 365-day test is not met on the date of declaration of dividend, i.e., 15th December 2021, SE Co. would be able to claim the concessional rate of tax if it continues holding its stake of 25% in IN Co. at least up to 31st March, 2022, i.e., 365 days from 1st April 2021. In such a case, when it files its tax return, it can claim the lower rate of tax of 5% as it has met the 365-day test as prescribed under the modified India-Serbia treaty.

ISSUES RELATED TO STRADDLE-HOLDING PERIOD

There are a few issues with regard to the straddle-holding period. Let us take the above illustration in which IN Co. would be paying a dividend to SE Co on 15th December, 2021. IN Co. needs to deduct tax at source u/s 195 of the Income-tax Act before making payment of the dividend to SE Co. Since the 365-day test is not met as on the date of payment, **can the concessional rate of tax be considered at the stage of deduction of tax at source?** There is no clarity or guidance on this aspect, but as the law stands, IN Co. may need to deduct tax at 15%, ignoring the concessional rate of tax of 5%, as it would not be able to ascertain whether SE Co. will or will not be able to meet the 365-day test in the future. An expectation, howsoever strong, of SE Co. meeting the 365-day test would not allow IN Co. to apply the lower rate on the date it needs to deduct tax at source. It should be noted that in such a case, SE Co. can still claim the concessional rate by filing its tax return and claiming a refund for the excess tax deducted at source by IN Co.

The above view finds favour with the Australian Tax Office, which has issued a similar explanation by way of "Straddle Holding Period Rule"[2] for its treaties modified by the MLI. A similar view has been expounded by the New Zealand Tax Office[3]. **A similar clarification from the Indian tax department would provide certainty on this aspect.**

Consider another illustration.

Illustration 7: SE Co. has invested 25% in shares of IN Co. on 1st February, 2022. Dividend has been declared by IN Co. on 28th February, 2022. As explained above, IN Co. would deduct tax at the higher rate of 15% as it would not be able to ascertain whether SE Co. would be in a position to meet the 365-day test or not. SE Co. would be able to meet the test only by 31st January, 2023. In this case, a further complication is that SE Co. would itself also face difficulty in claiming the concessional rate of tax in its tax return. This is because it would be required to file its tax return in India for A.Y. 2022-23 by either 30th September or 30th November, 2022. However, it would not

2 QC 60960

3 Commissioner's Statement CS 20/03

have met the 365-day test by the return-filing deadline. Even the extended deadline of 31st December, 2022 for filing a revised tax return would fall short for SE Co. in meeting the 365-day test prescribed under the modified treaty. Such a situation would lead to practical issues where although the claim would be held valid at a future date, it would be difficult to make such a claim in the tax return filed.

The above illustrations show how the otherwise simple and objective 365-day test can become a difficult claim for the company earning the dividend income in certain situations.

It must also be noted that the **365-day test is an objective test** – similar to the one for holding a prescribed minimum stake in shareholding or voting power. Such objective tests are prone to abuse. Consider a case where SE Co., in our illustration above, holds the stake in IN Co. for a period of 366 days, i.e.; it liquidates its stake as soon as the threshold period is met. It should be noted that the 365-day test is a simplistic representation of the income earner's substance requirement as far as cross-border shareholding is concerned. But as is the case with every such specific test, while clarity in the law is available, abuse of the provisions may still be possible, even if such an exercise becomes more difficult.

In such a case, it should be noted that this test is only one among many anti-tax avoidance measures that the MLI provides. The Principal Purpose Test, the Limitation of Benefits clauses, etc., are other anti-tax avoidance measures under the MLI which may come into play where it is proven that even the 365-day test has been abused.

CORPORATE REORGANISATION

The MLI considers situations where ownership has changed due to corporate reorganisations like mergers or demergers. The language provided in the Article 8 is as follows:

…for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividends.

Thus, the holding period of 365 days would apply across changes in ownership. The point to be noted is that such change would be ignored in ownership of the company that holds the share investment as also the company paying the dividends. Thus, both the parties to the dividend transaction need not consider the 365-day test from the date of reorganisation, but from the date of original holding. **The intent seems to be that corporate reorganisation would not entail a change in ultimate ownership, but only a change in the holding structure within the group – for which the holding period test should not be reset**.

CONCLUSION

To reiterate the above explanation in a few lines, **Article 8 of MLI provides an additional objective test to avail the concessional rate available for dividend incomes** under the treaties. The concessional rate is already subject to a minimum shareholding requirement. However, there was no compulsion of a minimum period for which such holding had to be maintained. This led to abuse of the relief provision. Through MLI Article 8, **treaties will now provide for a 365-day shareholding period. Shareholders who meet this test can avail the lower concessional rate.** However, as it is **not a mandatory article** of the MLI, at present **only 5 Indian treaties have been impacted**.

Taxation of dividend incomes has always remained an interesting topic for various reasons. The MLI provisions explained above make the subject even more interesting. Coupled with the recent controversies surrounding the applicability of Most Favoured Nation clauses (which is beyond the scope of the present article), we are ensured of interesting times ahead in the field of cross-border dividend taxation.

EPILOGUE

With this article, **BCAJ** completes a journey of over a year in providing a series of articles dealing with the most important aspects of the MLI – with a view to explain the provisions in as easy a manner as possible. The scope of the MLI provisions is vast, and it would not be possible for the **BCAJ** to cover all the myriad aspects. However, a reader wishing to avail a basic understanding of the MLI can access the articles starting from the April 2021 issue of the Journal. For readers interested in a deeper study of the subject, **BCAS** has published a **3 VOLUME COMPENDIUM ON THE MLI** spread over 18 Chapters authored by experts in the field, which is a must-read for every international tax practitioner. Further, a research

article **"MLI Decoded"** by **CA Ganesh Rajgopalan** provides a thread-bare analysis of each of the provisions of India's treaties modified by the MLI and is available as free e-publication on the BCAS Website at https://www.bcasonline.org/Files/ContentType/attachedfiles/index.html. ■

Articles in MLI Series (Volume 53 and 54 of BCAJ)

Sr. No	Title of the Article	Month of Publication
1	INTRODUCTION AND BACKGROUND OF MLI, INCLUDING APPLICABILITY, COMPATIBILITY AND EFFECT	April, 2021
2	DUAL RESIDENT ENTITIES – ARTICLE 4 OF MLI	May, 2021
3	ANTI-TAX AVOIDANCE MEASURES FOR CAPITAL GAINS: ARTICLE 9 OF MLI	June, 2021
4	MAP 2.0 – DISPUTE RESOLUTION FRAMEWORK UNDER THE MULTILATERAL CONVENTION	August, 2021
5	ANALYSIS OF ARTICLES 3, 5 & 11 OF THE MLI	September, 2021
6	ARTICLE 13: ARTIFICIAL AVOIDANCE OF PE THROUGH SPECIFIC ACTIVITY EXEMPTION	October, 2021
7	ARTICLE 10 – ANTI-ABUSE RULE FOR PEs SITUATED IN THIRD JURISDICTIONS (Part 1)	December, 2021
8	ARTICLE 10 – ANTI-ABUSE RULE FOR PEs SITUATED IN THIRD JURISDICTIONS (Part 2)	January, 2022
9	ARTICLE 6 – PURPOSE OF A COVERED TAX AGREEMENT AND ARTICLE 7 – PREVENTION OF TREATY ABUSE	February, 2022
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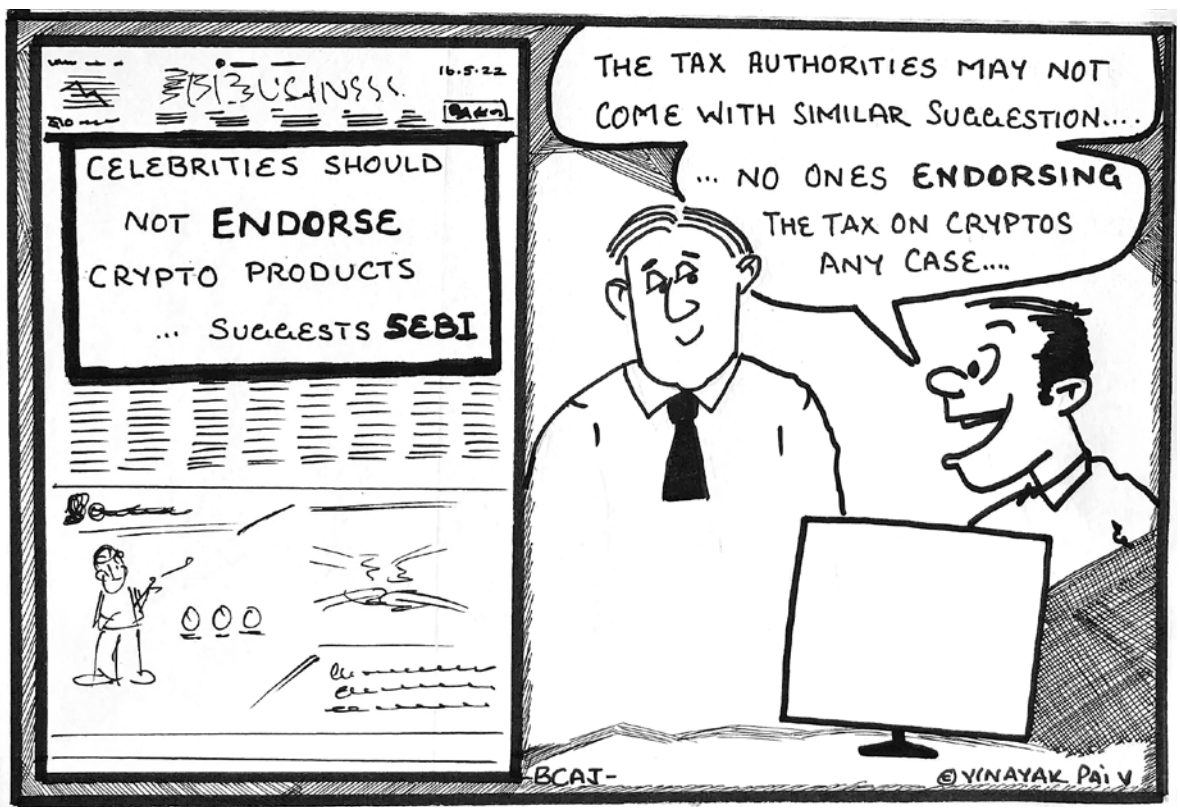

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