25 Key Excerpts from landmark Bombay HC judgment in Colorcon on DDT v DTAA tax rate controversy

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In a *judgment* which is a huge setback to Income tax Department, Bombay HC (at Goa) re-affirms tax treaty primacy while allowing the lower rate claim on Dividend Distribution Tax (DDT) by Colorcon; While adjudicating on whether the Rs 365 cr dividend payments made by Colorcon Asia/India to Colorcon UK would be entitled to a lower dividend distribution rate of 10% of Indo - UK DTAA, Bombay HC delves in detail on legislative history of Sec. 115 O of Income tax Act, fundamental principles of tax treaties, Apex Court judgments in *Tata Tea*, *Azadi Bachao* and *Engineering Analysis* etc.; HC repeatedly emphasises on the legislative 'alchemy' of Sec. 115-O, which according to the Court leads to an inference that "*DDT is a tax on dividend , which is income of the shareholder, but its incidence has been shifted to the company purely for administrative convenience...*"; Rejecting Revenue's arguments that DDT is merely an additional income tax and ought not to be construed as a tax on non-resident income, HC observes that "*While the DDT is a tax payable by the company, and not the shareholders, in pith and substance, it is a tax on dividends that is income of the shareholders.*"; On a reading of Article 11 of India - UK DTAA, HC opines that "*the person on whom the tax on dividend is levied is an irrelevant and extraneous consideration for its application. There is nothing in the Article which suggests that the income has to be taxed in India in the hands of the shareholders.... The nature of income is a apropos element to invoke the said Article, and not the person who is subjected to tax.* "; Allowing the assessee's writ petition against the Board for Advance Ruling's order, HC rules that there is no embargo in Article 11 of DTAA on the assessee to apply the lower tax rate stipulated in Article 11(2).

The judgment was delivered by a Division Bench of Justice Bharati Dangre and Justice Nivedita Mehta.

Sr. Adv. Porus Kaka, alongwith Adv. Manish Kanth and Adv. Terrence Sequeira argued for the assessee. Revenue was represented by Adv. Amira Razzaq.

Key Facts:

Colorcon paid dividend of Rs. 365 cr to Colorcon UK (spread over different AYs) and also paid DDT thereon at the rate specified under Section 115-O of the Act.

Controversy: whether Colorcon Asia Private Limited ('Colorcon India' or 'the Applicant' or 'Company') would be entitled to restrict the tax rate on dividends distributed or distributable by it to Colorcon Limited, United Kingdom UK), at 10 per cent under Article 11 (Dividends) of the India-UK Tax Treaty ("Tax Treaty").

Arguments by Sr. Adv. Porus Kaka:

- In light of the definition of the term 'Dividend' under the Act and by taking into consideration the legislative history surrounding the change insertion and repeal of Section 115-O on multiple occasions read alongwith the memorandum, offering the justification for such amendment, make it evident that DDT is nothing but tax on dividend, which is income of the shareholder, whose incidence has been shifted to the Company, but there is no change in its substantive concept or definition, but all the while shifting has occurred for 'Administrative convenience'.
- In light of the domestic law provision, DDT is levied on the dividend distributed by the Company, which is income of the shareholders and being an 'Additional tax' covered by the definition of 'tax' as defined in Section 2(43) of the Act, which fall within the ambit of charging Section 4 of

the Act, it is covered by provisions of the Act including Section 90.
- Any unilateral change made in the Domestic Law over the years merely in relation to the incidence of tax cannot alter or overwrite the beneficial provision of the Treaty.
- If India is permitted to charge a rate of tax in excess of the rate permitted under the Treaty on items of income, such as dividend as defined under the Treaty, it would not be in accordance with Article 24 and the credit would not be available, resulting in double taxation, which would defeat the object and purpose of the DTAA and will be contrary to the object and purpose of Dividend Distribution Tax.

Arguments by Revenue:

- As far as India's Double Taxation Avoidance Agreement (DTAA) is concerned, the dividend distribution tax is explicitly excluded from the scope of taxes covered under the agreement and in the wake of this being urged before us at the outset, she would submit that since DDT is not classified under the heading “Tax”, and hence the 10% withholding tax rates stipulated under Article 11 (2) would not apply and in such scenario, the dividend would be governed by Indian Tax Laws.
- Bilateral treaty between India and UK is silent and do not contemplate, DDT as a tax on shareholders similar to Indo-Hungarian Treaty and therefore the prayer to be governed by tax rate contemplated in Article 11 is completely misconceived.
- On reading of Section 115-O of the Income Tax Act, it is evident that the incidence as well as charge in respect of DDT is only on the domestic company that declares, distributes or has paid the dividend. On reading of the provision, it is her contention that the tax under section 115- O is an additional income tax, on the domestic company and by no stretch of imagination, DDT could be construed to mean as a tax on non resident dividend income, which is collected by domestic company.
- DDT is a tax on domestic resident company in India/ the appellant and not on the shareholder/resident of UK, and its levy does not give rise to any “Juridical double taxation”

Substantial Question of Law framed by HC : " *Whether the Dividend Distribution Tax (DDT) paid by the Colorcon Asia Pvt. Ltd, Verna, Goa, is to be governed by Double Tax Avoidance Agreement between (DTAA) between India and United Kingdom or it is to be dealt with in accordance with Section 115-O of the Income Tax Act, 1961?* "

HC Observations & Conclusions:

- From the above alchemy of Section 115-O, shifting the incidence of DDT, in light of the definition of the term ‘Dividend’ under the Income Tax Act with the legislative history referred to above, the provision in form of Section 115-O, being amended on more than one occasion, we safely lead to an inference that DDT is a tax on dividend , which is income of the shareholder, but its incidence has been shifted to the company purely for administrative convenience though there is no change in the substantive Rule or concept of ‘Dividend’.
- Since under the Income Tax Act, DDT is levied on Dividend distributed company, which amounts to income in the hands of shareholder and being “additional tax” it covered within the definition of Tax as defined in Section 2 (43) of the Act and since it is covered by Charging Section 4, it must be necessarily subservient to the provisions of the Act which include Section 90.
- With a specific provision in form of Sub- Section (2) of Section 90, it is made clear that once such a Treaty exist in form of an Agreement, then provisions of such an Agreement with respect to cases to which they apply would operate even if inconsistent with the provision of Income Tax Act.
- The observations in *Azadi Bachao Andolan* are also relevant as it throws light upon the principle to be adopted in interpretation of the treaty, which are held to be not the same as those in interpretation of statutory legislation.
- By quoting the following passage of Francis Bennion, it is held that, an important principle which needs to be kept in mind in interpreting the provisions of an international treaty, including the one for double taxation relief is, that treaties are negotiated and entered at political level and have several considerations as there basis. A Double Taxation Avoidance Treaty, should be seen in the context of aiding commercial relations between treaty partners as being essentially a bargain between two treaty countries as to the division of tax revenues between them in respect

of income falling to be taxed in both jurisdictions.

- Article 31 of the Vienna Convention on Law of Treaties (1969) (VCLT) also require that the treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of treaty in their context and in the light of its object and purpose. Article 31 of the General Rule of interpretation of VCLT when made applicable, to the case before us, when the question arises as to how the treaty shall be interpreted we get a clear answer in favour of the Appellant.
- Therefore, the effect of an International Treaty must override any provision in the domestic law and admittedly, Section 115-O being a part of domestic law, it must act as subservient to the treaty between India-UK (DTAA).
- Article 11 (India - UK DTAA) contains four elements to trigger its application, (a) the payment must be the dividend as defined in Article 11(3), (b) such dividend shall be paid by a resident of one state (India), (c) such dividend shall be paid to a resident of other state (UK), (d) such dividend, if beneficially owned by the resident of the of the other state (UK), the rate of tax in accordance with Article 11(2)(b) cannot exceed 10 per cent. Admittedly, on a plain reading of the terms of treaty, all four criteria are fully satisfied.
- India in good faith, is obliged not to tax this category of income at a rate greater than 10 per cent. it is undisputed in the fact placed before us that the payments made by the Appellant to the Colorcon UK are covered by the aforesaid deinition of dividend provided under the treaty.
- When the term ‘Income tax’ is specifically covered within the treaty it definitely include ‘dividend’ and in any case Article 2(1)(b) read with Article 2 (2) of the treaty include ‘Income Tax’ and any identical or substantially similar taxes imposed by India as ‘taxes’ covered for the purpose of India-UK DTAA. DTAA being an additional ‘income tax’ on such dividend, it is covered under Article 11(3) of the treaty and necessarily has to be charged in accordance with the rate prescribed.
- The unilateral change made in the domestic law over the years changing the incidence of tax, therefore, cannot, alter or override the beneficial provisions of the treaty. The courts are under an obligation within the legitimate limits to so interpret the municipal law as so to avoid confrontation with the treaties as well.
- The Apex Court (in *Engineering Analysis*) affirmed the principle laid down in Azadi Bachao (supra) to interpret the treaty liberally, with a view to implement the true intention of the parties and held that a important principle which needs to be kept in mind in interpretation of provision of international treaty, including one for double taxation relief is that the treaties are negotiated and several considerations are at their basis and ultimately it held that unilateral amendments at the domestic law cannot alter the treaty provisions...
- The decision in *DCIT Vs. Total Oil India Pvt. Ltd.* (ITAT Special Bench), which followed the dictum laid down by the Apex Court while deciding the nature of DDT under Section 115-O of the Act, particularly when the Apex Court in *Godrej & Boyce* (supra) was dealing with a different situation on different issue of disallowance of expenses under Section 14-A, if the tax payer earns any in exempt income. In contrast, the decision in Tata Tea (supra) has provided an answer that DDT is tax on dividend income and that is completely ignored by the authority.
- The amendment introduced by Finance Act of 2016 also make it apparent that the additional income tax in form of DDT is nothing but a tax on dividend income of shareholder and the explanatory memorandum to the Finance Bill of 2016, clearly noted as below...
- Sub-Section (1)(b) of Section 115-O, is the provision for grossing up of the dividend income of the shareholder for the purpose of computing DDT, but it always remain a tax on dividend, which can be declared out of companies reserves and it is not an additional income tax on profits of the company as even if the company is subject to loss during the financial year and do not pay income tax, but upon declaration of the dividend it is still required to pay DDT under sub-section (2), which make it clear that it is not a tax on profits of the company, but is tax on dividend.
- The submission of the Revenue that where a unilateral amendment shift only the incidents of tax for administrative convenience of one of the contracting States could render inoperable treaty obligations, without any amendment in the treaty, substantive or otherwise would be wholly contribute the good faith obligations contrary to the ordinary term of treaty and also to the law laid down in Azadi Bachao Andolan(supra) as well as Engineering Analysis...
- Considering that the international treaties involve extensive negotiations between two nations, and definitely being conscious of the respective Nation’s power to tax, the benefits and detriments of a treaty and particularly a double tax treaty and its avoidance, can only be reciprocal when the low of trade and investment between treaty partners rests on balance and it is not allowed for one treaty partner to secure benefit to detriment of other. When a treaty is

entered into, it is expected to have considered its impact on trade and investment and since it is mutual arrangement, it must be given full effect to and merely because there are unilateral amendments made on domestic front, the treaty cannot be made ineffective by construing the same in light of domestic law. The Parliament, is not within its power to change the terms of a bilateral treaty, which is a a result of negotiated economic bargain between India and UK.

- A party may not follow the treaty, it may choose to renege from its obligations thereunder, but it cannot amend the treaty on the guise of its domestic law, having undergone change. Amendments to domestic law, cannot be read into treaty provisions, without amending Treaty itself. Since it is necessary for the contracting party to fulfill their obligations under a Treaty in good faith and this includes its accountability under it and act in a manner, not to defeat its purpose and object, we ind that the benefit accruing under the DTAA, and Article 11 thereof, cannot be be denied as Revenue is of the opinion that the Treaty do not cover ‘Dividend’ or it is not applicable to a domestic company.
- According to us, the declaration, distribution or payment of dividend by company cannot in any manner be regarded as 'income ' of the company distributing the dividend. Even Section 2(24) has not been amended by the Legislature inasmuch as regarding the “amounts declared, distributed or paid by way of dividends” as “income” of the company distributing dividends. Moreover, the Hon’ble Supreme Court in UOI v. Tata Tea Co. Ltd. (supra), has, in no uncertain words, held that “income as defined in Section 2(24) of the 1961, Act is the inclusive definition including speciically ‘dividend’ and that “section 115-O pertain to declaration, distribution or payment of dividend by company and imposition of additional tax on dividend is thus clearly covered by subject as embraced by Entry 82 "
- Once the Hon'ble Supreme Court has held that dividend connotes ' income ', the natural corollary is that as per section 4, the said income should be chargeable to tax in the hands of the person earning such income. However, from a combined reading of Section 115-0 and 10(34), alongwith the legislative history narrated earlier, it is evident that DDT is a tax on the dividend income of the shareholder, though the incidence of tax has shifted from the shareholder to the company paying the dividend. Any other interpretation of the provisions will render the section 115-0 of the Act unconstitutional as it will fall foul of Entry 82, since what is sought to be taxed by the Respondent is not 'income' of the company.
- While the DDT is a tax payable by the company, and not the shareholders, in pith and substance, it is a tax on dividends that is income of the shareholders.
- Since DDT is an ‘Income Tax’ as per the provisions of the Act, it definitely fall within ambit of Article 2 of DTAA as income tax includes surcharge and dividend and Article 2 (2) clearly apply to any identical or substantially similar tax in addition to or in place of tax. DDT is squarely covered under Article 11 of the DTAA. On its plain reading the payment being covered under definition of dividend under Article 11(3) which is paid by the Company, resident of India to a resident of UK and therefore, in our view, Article 11(1) is automatically triggered, consequently triggering the restriction in rate of tax under Article 11(2).
- On a plain reading of the said Article, it is evident that the person on whom the tax on dividend is levied is an irrelevant and extraneous consideration for its application. There is nothing in the Article which suggests that the income has to be taxed in India in the hands of the shareholders. It merely deals with the nature of income, viz. dividend, which cannot be taxed in India at a rate exceeding 10%, if other stipulated conditions are met.
- The nature of income is a apropos element to invoke the said Article, and not the person who is subjected to tax, in whose hands the tax is levied, is not relevant for application of Article 11, as DDT is a ‘tax on dividend income of the shareholder’. The entire legislative history of Section 115-O corroborates this.
- Section 90(2) of the Act of 1961 allows the appellant to apply the lower rate under the DTAA and Article 11(2) restricts tax rate of such dividend income to 10% and there is no embargo in Article 11 of the DTAA on the Appellant to apply the lower tax rate stipulated in Article 11(2).
- Authority (BFAR) has erred in not appreciating that DDT erroneously collected in excess of 10% as provided by India-UK DTAA is erroneous and contrary to law and retention of excess tax would be contrary to Article 265 of the Constitution of India.