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TAX FLASH NEWS

10 April 2017

Tax credit can be claimed in respect of taxes deducted in the U.S.; restricted to rates prescribed in the India-USA tax treaty

Background

Recently, the Ahmedabad Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of Bhavin A Shah[1] (the taxpayer) held that the taxpayer can claim Foreign Tax Credit (FTC) in respect of taxes deducted in the U.S. against dividend income on the satisfaction of the conditions specified in the FTC Article of the India-USA tax treaty (tax treaty). Furthermore, where a tax deduction is at a rate higher than the rate prescribed in the tax treaty, the taxpayer will be eligible to claim FTC restricted to the amount computed based on the rates prescribed in the tax treaty.

Facts of the case

- The taxpayer is an individual, resident in India, and is in the employment of JP Morgan India Pvt Ltd as managing director and global head of technology research of the company.

- During the year under consideration, the taxpayer earned dividend income from foreign securities in the U.S. and the taxes withheld from such dividend income was of INR3,72,698. The taxpayer claimed a tax credit under Section 90 of the Income-tax Act, 1961 (the Act) in respect of the dividend income earned outside India.

- The Assessing Officer (AO) declined the tax credit claim of the taxpayer, in respect of tax of INR3,72,698 deducted from its dividend earnings in the U.S. on the ground that relief will be available on actual payment made in the return of income filed in USA and tax paid thereon, and tax credit cannot be given on simply Tax Deducted at Source (TDS) from foreign dividend income.

- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.

Tribunal's decision

- As long as the taxpayer has shown all the incomes in his income offered to tax, the tax credits are also to be granted in respect of the taxes withheld in the U.S. The manner in which tax credits are to be computed is provided under Article 25(2)(a) of the tax treaty. In so far as the rates at which dividend income of a resident of India can be brought to tax, the Tribunal referred Article 10 of the tax treaty.

- As long as a person, resident in India in terms of the tax treaty provisions, has been taxed in respect of his dividend earnings in the U.S., whether directly or by way of tax withholdings, in accordance with the provisions of Article 10 of the tax treaty, the tax credit will be available against his tax liability in India in respect of such dividend income, subject to the condition that such tax credit will not exceed the Indian income tax liability in respect of the income in question.

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[1] Bhavin A Shah v. ACIT (ITA No. 933/Ahd/2013) – Taxsutra.com

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- In order to avail the tax treaty benefits, it is not sufficient that the taxpayer is a 'resident' of India under the Act. The taxpayer is also required to satisfy the requirements of Article 4 of the tax treaty for being termed as 'resident of a contracting state', i.e. India.

- Therefore, in order to grant the tax credit, the AO has to first examine whether the taxpayer is a resident of India under Article 4 of the tax treaty, and the amounts shown by the taxpayer as dividends are actually in the nature of dividends. Further, the AO has to examine whether U.S. tax withholding is in accordance with the provisions of Article 10 of the tax treaty, and, if that be so, grant a FTC for the amount of such tax withholding or Indian tax liability in respect of the related income, whichever is less.

- In case the tax actually levied in U.S. is in excess of the rate specified under Article 10 of the tax treaty, the amount eligible for the tax credit will remain confined to the amount computed on the basis of the rate prescribed under the tax treaty.

- The taxpayer has filed detailed supporting evidences for tax withholding and the bank advices. Further, these details were also filed before the CIT(A) and the CIT(A) called for a remand report on the same but did not deal with the specifics of the matter beyond making generalised observations to the effect that 'some' of these tax withholding certificates did not mention the name of the taxpayer or were not signed by responsible persons.

- Though the taxpayer has filed these details, there are some apparent inconsistencies. The aggregate of these tax withholdings is much more than 25 per cent of U.S. dividend income, which, according to the provisions of the tax treaty, is the maximum permissible tax withholding under Article 10 of the tax treaty.

- When the Tribunal pointed out the above inconsistency, the taxpayer did accept the same. It was stated that the tax credit claim is almost 30 per cent of the amount of related dividend earnings, but the tax credit may be restricted to 25 per cent only.

- The course of action suggested by the taxpayer does seem an easy option, but it will not be a judicially correct option. There is no scope of sweeping generalisations while computing tax credit. The tax credit computation is to be done on a case-to-case basis, dealing with the tax levied in the other contracting state (i.e. U.S.) and the income in respect of which such tax is levied.

- As for 25 per cent withholding of tax from U.S. dividend income, it is not the applicable withholding rate but the maximum tax withholding rate. Therefore, it is not essential that the entire U.S. tax levy in respect of dividend income is at 25 per cent only. As a corollary to this position, the actual admissible withholding under Article 10 of the tax treaty is bound to be an amount lower than 25 per cent because, in some of the cases, the applicable U.S. tax rate could even be 15 per cent. There are some tax deductions at rates other than 15 per cent and 25 per cent.

- The tax credit in respect of this tax withholding as also other similarly placed securities, therefore, cannot be more than 20 per cent of dividend income in any event, even though the basis of 20 per cent tax withholding is not at all clear. It is also not clear which are the cases in which tax withholding rate is 10 per cent and in which cases the tax withholding rate is 25 per cent. While computing the admissible tax credits, all these aspects need to be examined, including whether the characterisation of income as the dividend is correct, so as to ensure correct tax credit computation.

- The Tribunal not inclined to accept the taxpayer's suggestion for restricting the tax credit to 25 per cent of the dividend income, nor it is proper to examine all these evidences in detail, for the first time at the stage of proceedings before the Tribunal.

- In our considered view, all these issues and evidences should be examined at the stage of the AO. Therefore, the matter is remitted to the file of the AO with the directions to compute the admissible tax credit in accordance with above observations.

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Our comments

The issue with respect to the claim of FTC has been a matter of litigation before courts/Tribunal.

The Tribunal in the present case has held that in order to grant the tax credit, the AO has to examine that the amounts shown by the taxpayer as dividends are actually in the nature of dividends and the tax deducted at source in the U.S. is in accordance with the provisions of Article 10 of the tax treaty. In case the tax deducted at source in the U.S. is in excess of the rate specified under Article 10 of the tax treaty, the amount eligible for the tax credit will remain confined to the amount computed on the basis of the rate prescribed under the tax treaty.

The Central Board of Direct Taxes has notified[2] FTC rules, which have come into effect from 1 April 2017. These rules clarify the nature and conditions for the availability of FTC to the taxpayers and provide guidance to claim FTC in India. The Tribunal's decision is in line with FTC rules, which provide that where foreign tax paid exceeds the amount of tax payable in accordance with the provisions of the applicable tax treaty, such excess shall be ignored for the purpose of computing FTC.

[2] CBDT Notification No. 54/2016, dated 27 June 2016

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