



# Tax Flash News



12 December 2025

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## Dividend Distribution Tax, effectively being a tax on dividend income of shareholder, cannot exceed tax treaty rate

### Executive summary



Prior to March 2020, the domestic companies were liable to pay an additional income-tax, Dividend Distribution Tax ('DDT'), on dividends declared, distributed, or paid to the shareholders (including non-resident shareholders). As the tax incidence was on the company paying the dividend (and not on the shareholders), the non-resident shareholders were not able to avail the beneficial tax rate provided in the applicable tax treaty for the dividend income. This led to significant litigation on whether DDT rate should be restricted to the tax treaty rate for dividend, with contrary decisions on this issue.

Recently, *the Bombay High Court*<sup>1</sup> held that DDT was, in substance, a tax on dividend income of shareholders, not on the company profits. Consequently, tax treaty provisions dealing with dividend taxation were applicable, and DDT paid by the Indian company on dividends distributed to its UK parent company should be restricted to 10 per cent as provided in the India-UK tax treaty ('the Treaty'), where the Treaty conditions are met. The High Court also held that the Revenue is at liberty to gross-up the tax rate in an appropriate manner.

<sup>1</sup> Tax Appeal No. 5 of 2024

## Facts of the case



The Petitioner, an Indian company, was a wholly owned subsidiary of UK-based company ('UKCo') which was a tax resident of UK.

During the financial years ('FYs') 2015-16 to 2018-19, the Petitioner distributed dividend to UKCo and paid DDT thereon at the specified rate of 15 per cent<sup>2</sup> under section 115-O of the Income-tax Act, 1961 ('the Act') which was higher than the tax rate of 10 per cent under Article 11 of the Treaty.

The Petitioner filed an application before the Board for Advance Rulings ('the BFAR') seeking an advance ruling<sup>3</sup> on whether it was entitled to restrict the DDT rate on dividends distributed by it to the Treaty rate and if so, whether the Treaty rate needs to be grossed up.

The BFAR, relying on the decision of the Mumbai Special Bench of the Tribunal in the case of *Total Oil India*,<sup>4</sup> held that DDT falls outside the scope of the Treaty as it is not included in the definition of the term "Taxes covered" provided under the Treaty.<sup>5</sup>

<sup>2</sup> During the relevant years, DDT rate was 15 per cent as increased by grossing up and surcharge and cess (Effective DDT rate ranges from 20.36 per cent to 20.56 per cent)

<sup>3</sup> Application for advance ruling was admitted under section 245R(2) of the Act in November 2019

<sup>4</sup> *DCIT v. Total Oil India (P.) Ltd.* [2023] 104 ITR(T) 1 (Mumbai Tribunal) (SB)

<sup>5</sup> Article 2

Aggrieved by the BFAR ruling, the Petitioner filed an appeal before the Bombay High Court.

## Relevant provisions



Erstwhile section 115-O of the Act imposed DDT as an additional income-tax on the amount declared, distributed, or paid as dividend by domestic companies, irrespective of whether the company had taxable income.

Article 11 of the Treaty provides that where dividend is paid by an Indian tax resident company to a UK tax resident, the tax rate cannot exceed 10 per cent of the gross amount of dividends if the beneficial owner of the dividends is a tax resident of UK.

## Petitioner's contentions



DDT is essentially a tax on dividend which is income in the hands of the shareholders and not in the hands of the company paying such dividend, though collected from such company for administrative convenience – only the incidence has been shifted from the shareholder to the company paying dividend.

This is supported by the legislative history surrounding the changes in the DDT provisions on multiple occasions read along with the explanatory memorandum to the relevant finance bills.

Any unilateral changes made in the provisions of the Act merely in relation to the incidence of tax cannot alter or overwrite the beneficial provisions of the Treaty.<sup>6</sup>

DDT falls within the ambit of charging provisions under the Act and is covered by the provisions of the Act, including section 90 which allows applicability of treaty provisions to the extent more beneficial to a taxpayer.

As the payment by the Petitioner to UKCo is in the nature of 'dividend' as defined under the Treaty, India was obliged not to tax dividend income at a rate greater than the Treaty rate.

If India levies tax on dividends at a rate higher than the Treaty rate, foreign tax credit would not be available to the recipient,<sup>7</sup> leading to double taxation. Such an outcome defeats the objective and purpose of the tax treaties and the DDT provisions.

In the case of *Tata Tea Company*<sup>8</sup>, the Supreme Court, in the context of dividend paid out of agricultural income, held that section 115-O is constitutionally valid and falls within the Indian Parliament's legislative competence under Entry 82 of List I (Union List) of the Constitution. While the initial source of income may be agriculture, once profits are distributed as dividends, they lose their agricultural character and become dividend income.

The Petitioner also relied on decisions in the case of *Giesecke & Devrient India*<sup>9</sup> and *Indian Oil Petronas*.<sup>10</sup>

## Revenue's contentions



Unlike the India-Hungary tax treaty, the India-UK tax treaty does not contemplate DDT as a tax on shareholder.

Since DDT is explicitly excluded from the scope of taxes covered under the Treaty, the rate prescribed in the Treaty does not apply, and dividend taxation would be governed exclusively by the relevant provisions of the Act.

<sup>6</sup> *UOI v. Azadi Bachao Andolan* [2003] 263 ITR 706 (SC); *Engineering Analysis Centre of Excellence (P.) Ltd. v. CIT* [2021] 432 ITR 471 (SC)

<sup>7</sup> Article 24 – Elimination of Double Taxation

<sup>8</sup> *UOI v. Tata Tea Company Limited* [2017] 398 ITR 260 (SC)

<sup>9</sup> *Giesecke & Devrient (India) (P.) Ltd. v. ACIT* [2020] 120 taxmann.com 338 (Delhi Tribunal)

<sup>10</sup> *DCIT v. Indian Oil Petronas (P.) Ltd.* [2021] 189 ITD 490 (Kolkata Tribunal)

DDT falls outside the scope of the Treaty as it is an additional income-tax payable over and above the income-tax chargeable on the company paying dividend. The incidence as well as charge in respect of DDT is only on the domestic company that distributes dividend, and by no stretch of imagination, DDT could be construed to mean as a tax on non-resident shareholders.

While the Treaty allows beneficial tax rate on dividends subject to the prescribed conditions, it also provides that the competent authorities of both the countries will agree on how to apply these limitations, and the Treaty provisions relating to dividend will not affect the taxation of the company in respect of the profits out of which dividends are paid. As there are no additional terms or mutual agreements prescribing the manner of applying the limitations related to dividend taxation under the Treaty, the assertion of the Petitioner that the dividend tax rate specified in the Treaty overrides DDT rate, is untenable.

Tax treaties must be interpreted strictly as per their text and unless discussed, deliberated, and documented in expressed terms, nothing is permitted to be inferred therein.

DDT is a tax on domestic company (i.e., the Petitioner) and not on the non-resident shareholder (i.e. UKCo), and its levy does not give rise to any “juridical double taxation”.

## High Court’s decision



The Bombay High Court reversed the BFAR ruling and held that the Petitioner is entitled to restrict the DDT rate to the Treaty rate. 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. The High Court also held that the Revenue is at liberty to gross-up the tax rate in an appropriate manner. Key observations included:

### *Nature of DDT*

DDT is not a tax on company profits, but a tax on the dividend income of the shareholders, with the incidence shifted to the company for administrative convenience, though there is no change in the substantive rule or concept of ‘dividend’.

DDT falls within the definition of “tax” under the Act and since it is covered by the charging provisions of section 4, it is subservient to section 90, making it subject to the Treaty provisions.

Definition of “income” under the Act includes “dividend”.<sup>11</sup> Section 115-O levies additional tax on the company on the “any amount declared, distributed or paid ... by way of dividends” which cannot in any manner be regarded as “income” of the company distributing the dividend.

### ***Tax treaties to override domestic law provisions***

Tax treaties prevail over domestic provisions where they conflict with the Act. Section 115-O being a part of the Act, it must act as subservient to the Treaty provisions.

Tax treaties allocate taxing rights between countries to prevent double taxation, and domestic law cannot override treaty obligations.

Negotiated at a political level, treaties aim to promote trade and investment. Courts interpret them liberally and in good faith, affirming treaty supremacy over unilateral amendments.<sup>12</sup>

The Vienna Convention also requires treaties to be interpreted in good faith. Although India is not a signatory to the Vienna Convention, its principles reflect customary international law and broad guidelines which should be considered when

interpreting domestic law. Within legitimate limits, courts are obliged to interpret statutes in a manner that avoids conflict with treaty obligations.

DDT collected in excess of the Treaty rate is erroneous and contrary to law, and retention of excess tax would be contrary to Article 265 of the Constitution of India.

### ***Analysis of the Treaty provisions***

The scope of taxes covered under the Treaty includes income-tax and any identical or substantially similar taxes imposed by India.<sup>13</sup> Since DDT is an income-tax as per the provisions of the Act, it is covered by the Treaty.

Since the dividend paid by the Petitioner to UKCo is covered within the definition of dividend under the Treaty, the beneficial Treaty rate is available in the instant case.

There is nothing in the Treaty which suggests that the dividend income should be taxed in India in the hands of the shareholders. The nature of income is a *proprio* element to invoke the Treaty provisions, and the person who is subjected to tax is not relevant for application of Treaty benefit.

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<sup>11</sup> Section 2(24)

<sup>12</sup> *Azadi Bachao Andolan (supra)*; *Sanofi Pasteur Holding SA v. Department of Revenue, Ministry of Finance* [2013] 354 ITR 316 (Andhra Pradesh)

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<sup>13</sup> Article 2

The concept of dividend has not undergone change either under the Act or the Treaty, but from the legislative history of section 115-O, it is noted that there is change in the incidence of tax under the Act from time to time for administrative convenience. Unilateral changes made in the Act changing the incidence of tax cannot, alter or override the beneficial provisions of the Treaty.

### ***Judicial precedents***

The High Court rejected the Revenue's reliance on the decision of *Total Oil India*, which followed the dictum laid down in *Godrej & Boyce* decision<sup>14</sup> as the latter decision dealt with a different issue relating to disallowance of expenses incurred to earn exempt income.<sup>15</sup>

The High Court followed the ratio laid down in the case of *Tata Tea Company* and *Giesecke & Devrient India*.

## **Our comments**



This decision reinforces primacy of tax treaties over domestic tax law. Domestic companies should review past dividend payouts to non-resident shareholders and assess eligibility for claiming refund on excess DDT paid thereon subject to applicable tax treaty provisions.



<sup>14</sup> *Godrej and Boyce Manufacturing Company Limited v. DCIT* [2010] 194 Taxman 203 (Bombay)

<sup>15</sup> Section 14A

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