Tax Flash News

26 July 2023

The Indian company is allowed to avail tax sparing credit under the India-Thailand tax treaty on the dividend income received from its Thailand subsidiary

Executive summary

A tax sparing credit mechanism in a tax treaty allows the resident country to give credit not only for taxes actually paid in the source country but also for taxes which would have been paid but exempted in the source country due to certain tax incentives.

Recently, the Delhi High Court in the case of Polyplex Corporation Ltd[1] (the taxpayer) dealt with the issue of eligibility of the Foreign Tax Credit (FTC) on the dividend income received by the Indian company on which tax was not paid by such Indian company in Thailand. The High Court allowed the tax sparing credit to the taxpayer under the India-Thailand tax treaty (the tax treaty). The High Court observed that such credit mechanism is engrafted in the tax treaty to incentivise investment for economic development. Thus, even though the actual tax was not paid in Thailand, the Indian company was allowed to avail FTC in India.

Facts of the case

- The taxpayer, an Indian company, received dividends from its Thai subsidiary company.
- The Thai subsidiary was granted exemption from corporate income tax vis-a-vis its net profit under the Thai Investment Promotion Act. Besides this, the dividend distributed by the Thai subsidiary was also exempt from tax under the Investment Promotion Act.
- The taxpayer claimed that under the tax sparing provisions of Article 23 of the tax treaty, it was entitled for foreign tax credit on the taxes which were payable but exempt on account of incentives granted by the source country.
- The taxpayer claimed the tax credit at the rate of 10 per cent of tax on dividend which would have been paid by the taxpayer if exemption was not provided.
- The Assessing Officer (AO) held that actual tax was not paid by the taxpayer on the dividend received from its Thai subsidiary and therefore, tax credit is not available on the dividend income.
- The Income-tax Appellate Tribunal (the Tribunal) allowed the tax credit to the taxpayer.

High Court's decision

The High court allowed the tax sparing credit to the taxpayer on the basis of following observations:

- Paragraph 3 of Article 23, employed a device of deeming fiction, includes in the expression 'Thai Tax Payable' which means that tax which would have been otherwise payable, but exempted because of specific incentive.
- Further Paragraph 6 of Article 23 provides a clue as to the rate at which tax credit can be accorded. It provides that it would be that rate of tax which would have been applicable, if income exempted from tax, had not been so exempted.
- Ordinarily the term 'tax payable' would mean tax, which is owed or due, although not paid. However, the meaning of the expression has to be found in the treaty executed between two contracting states. The tax treaties often (as in the instant case) define the term 'tax payable'.

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[1] PCIT v. Polyplex Corporation Ltd (ITA No. 571/2019) – Taxsutra.com

- The intent of the contracting states has to be ascertained from the term, as contained in the tax treaty, and not what would ordinarily be the meaning of a given expression or term. Therefore, the meaning of the expression 'Thai tax payable' or 'Indian tax payable' has to be found in the definition embedded in the tax treaty.

- On reference to plain reading of Article 23, credit for notional tax is granted to give a fillip and incentivise economic development. This decision was taken by contracting states and therefore, unless there is ambiguity, such interpretation is to be followed.

- The Revenue Code and the Investment Promotion Act of Thailand are specifically mentioned in Article 23(3) of the India-Thailand tax treaty. Thus, even though foreign law raises an issue of fact, which requires proof of the given fact, in the instant case no such proof was required.

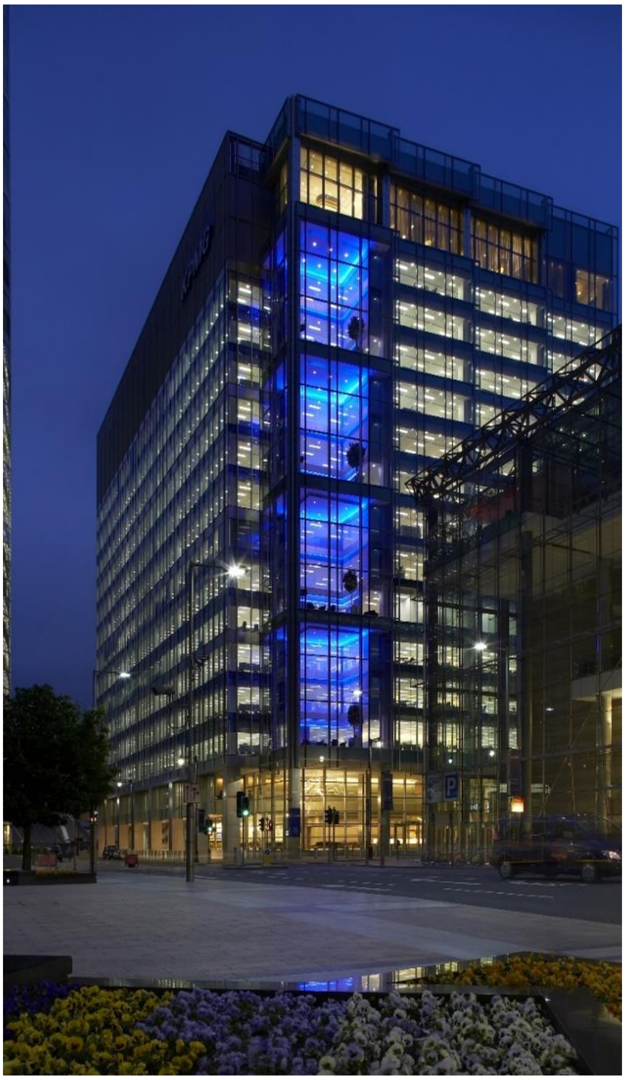
- Dividends are distributable profits, and if, net profit is exempt from corporate income tax, dividends could not possibly amenable to tax. Thus, the tax department's contention that the promotion certificate issued by the Board of Investment does not cover dividend income was not correct.

- The concept of tax sparing is embedded in several tax treaties which have been executed by India, such as with France, Jordan and Oman, apart from Thailand. Insofar as the India-Thailand tax treaty is concerned, credit for tax sparing works for residents of Thailand, as well as India. This is a mechanism which is engrafted in tax treaties to incentivise investment for economic development.

Our comments

The Delhi High Court has provided tax sparing credit to the Indian company on the basis of FTC Article of the tax treaty. Earlier, the Delhi High Court in the case of Krishak Bharati Cooperative Ltd[2], while dealing with the India-Oman tax treaty, allowed the tax sparing credit with respect to dividend income. Recently, the Supreme Court has heard tax department's appeal against Krishak Bharati Cooperative Ltd.'s decision and reserved its judgment.

It is important to note that the India-Thailand tax treaty has been amended in 2015[3] and the tax sparing credit has been removed from the tax treaty.



[2] PR. CIT v. Krishak Bharati Cooperative Ltd [2017] taxmann.com 326 (Del)

[3] Notification No. 88/2015, dated 1 December 2015

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