TREATY INTERPRETATION IN CROSS-BORDER DIVIDEND TAXATION

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Overview

This article analyses key interpretational issues in the taxation of cross-border dividends under India's tax treaty framework. Dividend taxation lies at the intersection of domestic income-tax law and bilateral conventions, requiring careful examination of characterisation, allocation of taxing rights and treaty entitlement.

The discussion traces the evolution of India's Dividend Distribution Tax (DDT) regime and the controversy arising from its interaction with tax treaties. The Bombay High Court's ruling in Colorcon Asia is examined as a significant judicial development, together with its subsequent implications.

The article also considers broader interpretational questions involving the treaty characterisation of buy-back transactions. It further analyses the role of beneficial ownership and the operation of Most Favoured Nation (MFN) clauses in determining treaty relief.

The article concludes that cross-border dividend taxation demands a structured analysis of domestic characterisation, treaty text and anti-abuse safeguards.

1. Introduction

The taxation of cross-border dividends lies at the intersection of domestic income-tax law and bilateral tax treaties. A dividend, in its classical sense, represents a distribution of profits by a company to its shareholders. In common parlance, dividend is income in the hands of the shareholder.

Under standard treaty principles (Article 10 of the OECD/UN Models), the Residence State has the primary right to tax dividend income, while the Source State (where the distributing company is resident) is also granted a concurrent but limited right, typically subject to a specified rate cap and conditions such as beneficial ownership.

Interpretational issues arise when domestic tax provisions of the Source State interact with treaty rules. Questions have arisen, for instance, on whether India's erstwhile Dividend Distribution Tax (DDT) was a tax on company profits or on shareholder dividend income for treaty purposes. Similar

Interpretational issues arise when domestic tax provisions of the Source State interact with treaty rules.

complexities arise in distinguishing buy-back distributions from dividends. The application of independent treaty concepts like beneficial ownership and MFN clauses further illustrate the complexity of treaty interpretation in dividend taxation.

Accordingly, treaty interpretation in dividend taxation requires a careful analysis of domestic characterisation, treaty allocation of taxing rights, and autonomous treaty principles to ensure consistency with international obligations.

This article examines certain nuanced aspects of these interpretational challenges in cross-border dividend taxation.

2. The Dividend Distribution Tax Regime and the Treaty Interface

2.1. Legislative Background

India's approach to dividend taxation has witnessed a cyclical evolution between two competing models, the classical system and the DDT regime. Under the classical system, dividend income was taxed in the hands of the shareholder. In contrast, the DDT regime, introduced by the Finance Act, 1997 through insertion of section 115-O of the Income-tax Act, 1961, shifted the incidence of tax to the distributing company by imposing an additional income-tax on dividends declared, distributed or paid.

Although withdrawn in 2002 and reintroduced in 2003 for administrative convenience, the DDT regime continued with modifications, including introduction of grossing-up provisions, until its abolition by the Finance Act, 2020, which restored shareholder-level taxation.

2.2. *The DDT–DTAA Rate Controversy*

The DDT regime, though now repealed, generated significant controversy in cross-border contexts. The core issue was whether DDT u/s 115-O applied independently of treaty limitations or was subject to the concessional rate on dividends under the relevant tax treaty.

The dispute centred on the character of DDT, whether it was a tax on the distributing company's profits or, in substance, a tax on shareholder's income collected at the company level. This distinction directly impacted treaty applicability and led to refund claims for DDT paid in excess of treaty caps. The dispute culminated in divergent rulings[1], leading to the Special Bench decision in Total Oil India[2], before being authoritatively addressed by the Bombay High Court in Colorcon Asia[3].

2.3. *The Bombay High Court's Ruling in Colorcon Asia*

In Colorcon Asia, the assessee, an Indian company and wholly owned subsidiary of a UK resident company, paid dividends to its UK parent and discharged DDT u/s 115-O. It sought an advance ruling on whether the tax rate could be restricted to 10% under Article 11 of the India–UK DTAA. The Board for Advance Rulings (BAR) rejected the claim, holding that DDT was outside the scope of the DTAA.

Allowing the appeal, the Bombay High Court set aside the BAR ruling and held as follows:

- ***DDT is a tax on dividend income of the shareholder:*** The Court held that DDT u/s 115-O is an additional income-tax in respect of dividend income. Though the statutory liability to pay rests on the company, in pith and substance it is a tax on dividends, i.e., income of the shareholder.

- ***Legislative history confirms administrative shift of incidence:*** On a conjoint reading of the Memorandum to the Finance Bills (1997, 2003 and subsequent amendments), the Court observed that the shift of tax incidence to the company was for administrative convenience and did not alter the substantive character of dividend as shareholder income.

- ***DDT qualifies as "income-tax" under the DTAA:*** Being an income-tax within the meaning of section 2(43) and referable to section 4 of the Act, DDT falls within Article 2 of the India–UK DTAA, which covers income-tax and any identical or substantially similar taxes.

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1. *Giesecke & Devrient (India) (P.) Ltd. v. ACIT CIT [2020] 120 taxmann.com 338 (Delhi Trib.), DCIT v. Indian Oil Petronas (P.) Ltd [2021] 189 ITD 490 (Kol Trib); Intertek India (P.) Ltd. v. ACIT [2025] 176 taxmann.com 186 (Delhi - Trib.)*
2. *DCIT v. Total Oil India (P.) Ltd. [2023] 149 taxmann.com 332 (Mum-Trib) (SB)*
3. *Colorcon Asia (P.) Ltd. v. JCIT [2025] 181 taxmann.com 301 (Bom HC)*

- ***Article 11 applies based on nature of income***: Where the payment qualifies as "dividend" under Article 11(3) and is paid by an Indian resident company to a UK resident beneficial owner, Article 11(2) limits India's taxing right to 10%. The applicability of Article 11 depends on the nature of income, not on the identity of the person remitting the tax.

- ***Section 90(2) ensures treaty override:*** Since section 90(2) mandates that treaty provisions prevail where more beneficial, DDT cannot be levied in excess of the rate permitted under Article 11 of the DTAA.

- ***Godrej & Boyce distinguished;*** Tata Tea followed: The Court distinguished Godrej & Boyce Mfg. Co. Ltd.[4] as arising in the context of section 14A and relied on Tata Tea Co. Ltd.[5], which recognised DDT as a tax on dividend income.

- The ruling of the BAR was set aside. The assessee was held entitled to restrict the tax rate on dividends distributed to its UK parent to 10% under Article 11 with liberty to the Revenue to gross up the tax in accordance with law.

2.4. *Post Colorcon developments*

With the abolition of DDT by the Finance Act, 2020 and the restoration of the classical system, dividends are now taxed in the hands of shareholders and subject to withholding u/s 195 in case of non-residents. Consequently, the Colorcon controversy does not arise prospectively. However, for assessment years prior to 2020-21, the ruling retains substantial relevance.

The ratio of Colorcon has found early acceptance at the tribunal level. In *Sophos Technologies*[6], the Ahmedabad Bench applied the High Court's reasoning and restricted DDT to the treaty rate. Similarly, in *Mitsui Kinzoku Components*[7], the Delhi Bench granted relief by applying the dividend article of the relevant DTAA.

The Revenue has, however, continued to contest the correctness of Colorcon and has reportedly sought reference of the issue to a larger Bench of the Bombay High Court. Independently, a Special Leave Petition has been filed before the Supreme Court against the judgment, which is stated to be listed for initial hearing in March 2026.

2.5. *Structural and Interpretational Considerations*

While the matter presently remains sub-judice, certain structural and interpretational issues continue to merit examination in the broader debate on DDT and treaty application.

(i) Absence of Deeming Clause similar to Indo-Hungary DTAA

The Indo-Hungary DTAA contains an express deeming provision to the effect

4. *Godrej &Boyce Mfg. Co. Ltd. v. CIT [2010] 328 ITR 81 (Bom HC)*
5. *UOI v. Tata Tea Company Limited [2017] 398 ITR 260 (SC)*
6. *Sophos Technologies (P.) Ltd. v. DCIT [2026] 183 taxmann.com 87 (Ahmd Trib.)*
7. *Mitsui Kinzoku Components India (P.) Ltd. v. CIT(A) [2026] 183 taxmann.com 659 (Delhi Trib.)*

that where a company resident in India pays dividends, the tax on distributed profits shall be deemed to be taxed in the hands of the shareholders and shall not exceed the specified percentage of the gross dividend.

No comparable clause exists in the India–UK DTAA or other Indian treaties. The absence of such an express deeming fiction raises the question whether treaty rate limitation was intended to extend to a company-level levy such as DDT in the absence of specific language treating distributed profits as shareholder taxation.

(ii) Scope of Article 2 – Taxes Covered

Article 2 of the India–UK DTAA covers "income-tax including surcharge thereon" and extends to "any identical or substantially similar taxes" imposed after the date of signature, subject to notification between the competent authorities.

An argument may arise as to whether DDT, introduced after the treaty, qualifies as a substantially similar tax and whether the procedural requirement of notification assumes relevance in determining treaty coverage.

(iii) Structure of Article 11 of Indo-UK DTAA – Whether treaty benefit confined to Recipient?

A textual reading of Article 11 may suggest that the treaty benefit is intended for the recipient of dividend income:

No comparable clause exists in the India–UK DTAA or other Indian treaties.

- "Dividends paid… to a resident of the other Contracting State may be taxed in that other State."
- Source State taxation is limited only if the "beneficial owner" of the dividends is a resident of the other Contracting State
- "Dividends" are defined as "income" from shares.
- Article 11 does not apply where the "beneficial owner" has a permanent establishment in the Source State and the holding is effectively connected with such PE.

These elements arguably indicate that Article 11 is structured around the taxation of the shareholder's income. The extent to which such a framework accommodates a levy imposed on the distributing company, albeit in respect of dividend income, remains a point of interpretational analysis.

(iv) Juridical vs. Economic Double Taxation

Tax treaties are generally directed at mitigating juridical double taxation, i.e., taxation of the same income in the hands of the same person in two States. Under the DDT regime, dividend income was exempt in the hands of shareholders u/s 10(34). Consequently, there was arguably no juridical double taxation of the shareholder.

The issue therefore arises whether the treaty was intended to extend relief in circumstances involving only economic double taxation, and whether extending the treaty benefit to the company distributing dividends was within the contemplation of the contracting States.

(v) Dual Character of Section 115-O

A textual reading of section 115-O, independent of the rationale of administrative convenience, reflects features supporting both characterisations:

Indicative of tax on distributed profits of the company

- Sub-section (1) describes DDT as an "additional income-tax" and as "tax on distributed profits."
- Sub-section (1A) allows reduction of dividend received from domestic or foreign companies before computing DDT.

Indicative of tax on shareholder's income:

- Sub-section (2) requires payment of DDT even where no income-tax is payable on the company's total income.
- Sub-section (1B) provides for grossing up of dividend for computing DDT.
- Sub-section (4) treats DDT as final tax in respect of the amount declared, distributed or paid as dividends.

The distinction between dividend and buy-back assumes importance in cross-border taxation because treaty allocation of taxing rights depends on the character of the income.

These dual features reflect the hybrid nature of DDT and form the core of the interpretational divide that animated the DDT versus DTAA rate controversy.

3. BuyBack versus Dividend – Treaty Characterisation

The distinction between dividend and buy-back assumes importance in cross-border taxation because treaty allocation of taxing rights depends on the character of the income. While a dividend is a distribution of profits, a buy-back involves the company purchasing its own shares resulting in extinguishment of shareholder rights.

Under domestic law, the tax treatment of buy-back has shifted over time, at different stages being taxed as capital gains in the hands of shareholders, then subject to company-level levy (Buy-Back Tax), then being taxable as deemed dividend and now reverting to capital gains in hands of shareholder. In case of foreign shareholders, the critical issue is how the payment is characterised under the relevant treaty article.

Most Indian treaties define "dividends" as income from shares, participating rights and other corporate rights which are subjected to the same taxation treatment as income from shares under the laws of the distributing State. This extended definition creates interpretative space where buy-back payments represent accumulated profits. The question that arises

is whether consideration received on buy-back constitutes income from shares or other corporate rights or proceeds from alienation of shares.

The OECD Commentary offers interpretative guidance:

- Paragraph 31 of Article 13 recognises that where shares are redeemed or capital is reduced, the excess of proceeds over par value may be treated by the State of the company as a distribution of accumulated profits rather than capital gains.

- Paragraph 28 of Article 10 clarifies that distributions treated as dividends under domestic law may fall within the dividend article, even if arising on redemption of shares. At the same time, the Commentary notes that distributions that effectively reimburse capital and reduce membership rights are normally not regarded as dividends.

Therefore, treaty characterisation depends on:

- Whether domestic law treats the payment as dividend;

- Whether the payment represents distribution of accumulated profits;

- Whether the transaction results in reduction of shareholding or extinguishment of rights;

- The wording of the specific treaty definition.

The buy-back question mirrors the DDT controversy in a structural sense: both involve domestic tax design affecting treaty characterisation. The key enquiry remains whether the income falls within Article 10 (Dividend) or Article 13 (Capital Gains).

- If characterised as dividend, source taxation may be capped under Article 10.

- If characterised as capital gains, taxing rights may allocated under Article 13 (subject to specific treaty clauses).

Ultimately, the characterisation of buy-back proceeds under a treaty must be determined by a careful reading of the treaty text along with the domestic law and the substance of the transaction, as it directly governs the treaty entitlement, allocation and limitation of taxing rights between the contracting States.

4. Beneficial Ownership

The concept of "beneficial ownership" is central to treaty-based dividend taxation. Most Indian tax treaties, following Article 10 of the OECD and UN Model Conventions, restrict the source State's right to tax dividends to situations where the recipient is the "beneficial owner" of such income.

The term "beneficial owner" is not defined in tax treaties. The concept was introduced in the 1977 OECD Model to counter treaty-shopping arrangements. The OECD Commentary does not offer a positive definition; instead, it explains what does not constitute beneficial ownership. Agents, nominees and conduit companies acting as fiduciaries or administrators are not regarded as beneficial owners where their right to use and enjoy the income is constrained by a contractual or legal obligation to pass it on. The emphasis is therefore on "dominion and control" over the income and a purposive interpretation aligned with the object of preventing abuse.

International jurisprudence has consistently endorsed this substance-based approach. In ***Indofood International Finance Ltd. v. JP Morgan Chase Bank (2006 EWCA Civ 158),*** the English Court of Appeal held that the beneficial owner is one who enjoys the "full privilege" of directly benefiting from the income. In ***Prévost Car Inc. v. The Queen (2008 TCC 231),*** the Canadian court recognised beneficial ownership where the intermediary retained discretion over the dividend and was not legally bound to pass it on. Similarly, in ***Golden Bella Holdings Ltd***.[8], the Mumbai Tribunal emphasised exclusive possession, control and freedom to utilise income without obligation as key determinants.

In practice, the enquiry is fact-intensive. Indicative factors in determining beneficial ownership include:

(a) Right to use and enjoy the income, unconstrained by any contractual or legal obligations i.e. dominion and control over the income; power of disposal of income;

(b) Absence of obligation to pass on the passive income;

(c) Direct recipient of income does not act as an agent, nominee or conduit company acting as a mere fiduciary or administrator;

(d) Organisation structure of the company and business activities of the members;

(e) Funding of investments (own funds or borrowed funds);

(f) Ownership of the property (say, shares) and rights therein (say, voting rights in the shares);

(g) Ability of parent to exert significant influence over management and activities of subsidiaries;

(h) Substantive business activity and presence of office, assets, employees, etc.;

(i) Assumption of risks viz foreign exchange risk, counter party risk, shareholder's risk, etc.

(j) Examination of legal and contractual documents; etc.

5. Most Favoured Nation Clause

Certain Indian tax treaties (e.g., with the Netherlands, France and Switzerland) contain Most Favoured Nation (MFN) clauses in their Protocols. These clauses inter alia provide that if India subsequently enters into a treaty with a third State (which is a member of the OECD member) granting a lower rate of tax on dividends, the same concessional rate shall apply under the earlier treaty.

India's treaties with Lithuania, Colombia and Slovenia prescribed a 5% dividend tax rate. Although these countries were not OECD members at the time of signing their treaties with India, they became members subsequently, giving rise to interpretational disputes.

The controversy centred two principal issues:

8. *Golden Bella Holdings Ltd v. DCIT (Intl Taxn) [2019] 109 taxmann.com 83 (Mum Trib)*

(i) Automatic application vs. notification – Whether the reduced rate or scope applies automatically upon India signing a more favourable treaty, or whether a separate notification u/s 90 of the Income-tax Act, 1961 is required.

(ii) OECD membership timing – Whether the third State must be an OECD member at the time of signing the original treaty or whether subsequent OECD accession suffices.

In Nestle SA[9], the Supreme Court held that a notification u/s 90 is necessary to operationalise MFN benefits and that the third State must be an OECD member at the time of entering into the treaty with India for the MFN clause to apply. The Central Government earlier clarified the same position in Circular No. 3/2022 dated February 03, 2022, regarding the applicability of MFN clauses.

Following this ruling, the Swiss competent authority, which had earlier accepted extension of the lower dividend rate under the MFN clause of the Indo-Switzerland DTAA, suspended the unilateral application of the MFN benefit with effect from 1 January 2025, reverting to the original treaty rate.

Separately, India and France have recently signed an amending protocol to the tax treaty introducing a split dividend tax rate of 5% (for shareholding of at least 10%) and 15% in other cases. The protocol is presently pending entry into force.

6. Conclusion

Cross-border dividend taxation reflects the delicate interface between domestic tax design and treaty allocation of taxing rights. Issues such as DDT, buy-back characterisation and MFN clauses ultimately turn on treaty interpretation and the proper classification of income under the relevant article.

However, treaty relief is not automatic. Conditions such as beneficial ownership, Limitation of Benefits (LOB) clauses and the Principal Purpose Test (PPT) act as substantive safeguards.

Accordingly, dividend taxation under treaties requires careful analysis of characterisation, allocation of taxing rights, treaty entitlement and anti-abuse standards, so as to ensure coherence with international treaty obligations. ■

9. *AO (Intl Taxn) v. Nestle SA [2023] 458 ITR 756 (SC)*

" In a conflict between the heart and the brain, follow your heart. "

Swami Vivekanand