Dividend Distribution TAX (DDT) in India

Prof. (Dr.) Vishwajeet V. Jituri  
(vvjituri@yahoo.com)

Abstract
The shareholders invest for getting return on their investments; these could be in the form of dividends and/or capital gains from a capital market. Looking into this aspect, the Companies also try to maintain a balance between dividend and capital appreciation in their profit-sharing policy. The classical method of charging tax on dividend income in India was through the recipient of the dividend. Post 1997, the Government changed this method by applying dividend distribution tax (DDT) on the Companies distributing the dividend and the dividend income became tax exempt in the hands of the recipients. There were some issues faced by Corporates, non-resident shareholders and low-income bracket people. Thereafter, in Budget 2020, the Government has abolished DDT. This paper describes some of the aspects related with dividend distribution tax.

Keywords
Dividend, capital gain, dividend distribution tax (DDT), shareholder, tax

Introduction
The Companies earn profit in their operation and may distribute the same to their shareholders. This is called as Dividend. For the shareholders, the dividend is generally a steady flow of income; besides that, they can achieve capital gain from selling their stocks.

To attract the people and keep them latched with the stocks, many Companies declare and distribute large portion of their profits as dividends. The Companies may also keep a portion of their profit to pump it again in the operations for overall growth of the Company. The dividend may be distributed as interim dividend, which is paid one or more times in a financial year and/or final dividend which is paid once in a financial year after the preparation of the annual financial statements. (MSTC)

The profit which is retained by the Company is likely to give more capital gain to the shareholders in future. However, the shareholders differ in their thinking; some want dividend upfront, whereas others might prefer capital gain in long term. Therefore, the Companies tries to maintain a balance between dividend and the retained profit for business growth activities.

In past, there has been lot of debate and thought process whether dividend pay-out policy and amount have any impact on the Company’s growth, investment opportunities, capability to attract shareholders etc.? Assuming that there could be different rates of taxation on dividend and capital gain, this impacts the shareholders’ perspective. If the taxation on say dividend is less, the shareholders and the Company might want to provide more proportion of the business profit as dividend, as it increases their net income.

The differential tax rates on dividend and capital gain constitutes an imperfection in the capital market. In many countries, dividend is taxed at a higher rate as compared to capital gain. Moreover, the tax rate itself may vary among the type of the investors; some investors being taxed more heavily than others. When the dividends are taxed at a higher rate as compared to capital gains, the investors are likely to nurture the Companies with low dividend rate pay-out, in order to get better capital gain. And the same could be true vice-versa too.
If dividends are taxed more heavily than capital gains, it seems plausible that investors would foster companies with low dividend rate because of the high tax burden. Farrar and Selwyn (1967) and Brennan (1970) concluded after many studies that; if the tax rate on dividends is higher than that of capital gains, optimal distribution policy offers no dividend. The second form of distribution, share repurchases, thus implicitly suggested to pay the excess flow of the company. (Lamyaa & Karima, 2017)

As per an article by Modigliani and Miller (1961), in absence of difference in taxation rates of dividends and capital gains in a perfect financial market, the dividend policy doesn’t affect the share value. The shareholders are rational and satisfied with their profit portion distributed in either way (dividend or capital gain). (Lamyaa & Karima, 2017)

However, in real world, there is variety of taxation system in various countries. The tax rates are generally tilted in the favour of less wealthy people. But it is difficult to apply the desired tax rates practically. Same issue may appear during distribution of the Company’s profit by way of the dividend.

If the dividend is taxed at Company’s level, meaning that it is tax-free in the hands of shareholder, then the wealthy shareholders who are in the higher tax bracket are benefited more, because less tax is paid by them. This causes inequality in the desired tax application system. In case the Company releases the dividend without deducting tax and the tax is to be paid by the shareholders, then the shareholders get taxed as per their income bracket and then the intended equality is retained.

The shareholders’ decision to go for dividend or capital gain also depends upon the horizon of the investment. A short-term shareholder would like to see more capital gain, whereas a long-term shareholder might want regular and higher value of dividends and followed by long-term appreciation of the capital. However, there are no hard or fast rules for this assumption.

Till 1997, every domestic company was required to withhold tax\textsuperscript{1} on the payment of dividend at the prescribed rate and issue a TDS\textsuperscript{2} certificate to the shareholder. The shareholders were then liable to pay tax on such dividend at a specified rate, and also considering the TDS. This process led to complex collection and administrative issues on taxation of the dividend. Therefore, in order to make the collection of tax on dividend administratively easier, the Government vide Finance Act, 1997 came out with section 115-O which had provision for ‘Dividend Distribution Tax’ (DDT). The DDT was inserted as an additional income tax on the company itself and as a result such dividend income was exempt in the hands of shareholders under section 10(34). (Ali, 2020)

Over a period, many changes were carried out under the Income-tax Act, 1961 in the context of DDT. The Finance Act, 2014 provided for grossing up of DDT rate in order to ensure that DDT is deducted on gross amount. Thereafter, Finance Act, 2017 inserted another section to provide for additional rate of tax @10% in the hands of shareholders, in case of receiving more than Rs. 1 million of dividend. (Ali, 2020)

Until 2019, the taxation system in India was: Capital gain was taxed at prescribed rates in the hands of the recipient (shareholder) and the tax on dividend was deducted by the Company while distributing the dividend (@15% plus surcharge and education cess, resulting in effective tax rate of 20.56%) and called as Dividend Distribution Tax (DDT).

\textsuperscript{1} In case of dividend exceeding of Rs. 2500
\textsuperscript{2} Tax deducted at source
Besides the equity share market in India, the mutual fund market is also huge. The mutual funds too involve dividend and capital gain aspects. The tax treatment in case of mutual funds is somewhat different as compared to the equity shares. The DDT era tax rates on mutual funds for an Individual is given in Table 1. (SBI Mutual Fund)

<table>
<thead>
<tr>
<th>Dividend distribution tax (DDT)</th>
<th>Equity oriented schemes</th>
<th>Debt oriented schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>NIL</td>
<td>NIL</td>
</tr>
<tr>
<td>Dividend distribution tax</td>
<td>10%</td>
<td>25%</td>
</tr>
<tr>
<td>(DDT)</td>
<td>+ 12% surcharge + 4% cess = 11.648%</td>
<td>+ 12% surcharge + 4% cess = 29.12%</td>
</tr>
<tr>
<td>Long term capital gains</td>
<td>10%</td>
<td>20%</td>
</tr>
<tr>
<td>Short term capital gains</td>
<td>15%</td>
<td>As per income tax bracket</td>
</tr>
</tbody>
</table>

Noting that the income tax bracket for an Individual in India varies from nil tax to 30%+ tax, the DDT imposed uniform tax rate on all, irrespective of their income levels. Also, the dividend recipient was not allowed any expense deduction as per the income tax regulation Section 14A (any expense concerning income not forming part of total income would not be allowed as deduction). Due to this section, the Corporates or big investors could not claim any expense deduction (like salary of employees engaged in making investments, fee paid to investment advisors etc.) while working to get the dividends.

For foreign investors (non-resident shareholders), DDT imposed a tax credit issue. Normally, a foreign investor can get credit in the home country for the tax deducted in other countries, in order to prevent double taxation. However, as DDT was in the nature of ‘tax on distribution’, there was a question whether a credit would be allowed against DDT. (Saiya, 2020)

DDT also poses an issue if a Company decides to give full profit as dividend to the shareholders. Consider an example:

- A Company has Rs. 100 as profit from their operations.
- If they wish to distribute Rs. 50 to the shareholders, DDT would be applicable @20.56%. So, retained profit with the Company would be Rs. 39.72 [Rs. 100 minus Rs. 50 (dividend) minus Rs. 10.28 (DDT)].
- Now, assume that the Company wishes to give full Rs. 100 as dividend to the shareholders. In this case, there is no money left in the profit to provide for DDT. That means the DDT will erode the capital of the Company, in other words capital of the shareholders.

In Union Budget 2020, the Government has abolished the Dividend Distribution Tax (DDT) and reverted to the earlier classical system of tax being payable at the hands of recipient of the dividend. However, the Company has to withhold tax (TDS) @10% at their end for dividend payment of more than Rs. 5000 to a resident shareholder.

This is applauded as a big relief for Corporates and non-resident shareholders. Because the Corporates can now claim expenses towards earning of the dividend (like salary of employees engaged in making investments, fee paid to investment advisors etc.) in their tax calculations, though it will be limited to maximum 20% of the dividend income.

Similarly, non-resident shareholders can avoid being charged double taxation. The tax rate for them has been specified as 20% on dividend income. Also, a non-resident shareholder can also apply the rate given in respective tax-treaty applying the beneficial provision under section 90(2). (Ali, 2020)

---

3For the FY 2020-21, the rate of TDS stands reduced to 7.5% for dividends paid till 31 March 2021.
To prevent the cascading effect of taxes on dividend received by a domestic Company from another domestic Company, Section 80M has been introduced in the Budget 2020. Section 80M permits a deduction from the dividend income received by a domestic Company (say A) from another domestic Company (say B) of the onward distribution of dividend by the Company A, before computing the tax payable by the Company A on the taxable dividend income. (Deloitte, 2020)

Conclusion

The impact of abolishment of DDT on Individual shareholders would depend upon their total income. The people in lower tax bracket would gain, whereas the people in the higher tax bracket will have to pay more tax now. Accordingly, the shareholders may then consider shifting their investments between dividend orientation or capital gain orientation, so as to get the maximum benefits.

In view of the above arguments, the shareholders may make their investment decisions accordingly and try to derive the maximum profit in the process.

Disclaimer: The information in this paper has been gathered from open sources, is for general information purposes only, does not constitute any legal or tax advice and has no relation with the author's/editors' thinking, beliefs or opinions etc. This information is not intended for giving business advice/decisions. Any action taken by you based on the information contained herein will be your responsibility alone and the author/editor will not be liable in any manner for the consequences of any such action taken by you.

Bibliography


