Budget 2020: Going back to old ways, dividends now taxed in the hands of shareholders

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Indruj Singh Rai

The Finance Bill, 2020, has made substantial changes to the manner in which dividends are taxed. Presently, dividends distributed by a company are subject to dividend distribution tax (DDT) at an effective rate of 20.56 percent.

Further, DDT is levied on post-tax income of the company i.e. after the company has already paid corporate tax on its profits. Such DDT is not available as a credit to the shareholder since it is the tax obligation of the distributing company and not the shareholder i.e. DDT is not in the nature of deduction of tax at source.

In addition to DDT, non-corporate shareholders such as individuals, Trusts, Associations of Persons, Firms etc. would pay an additional tax at the rate of 10 percent (increased by surcharge and cess) on dividends received in excess of Rs 10 lakhs. Non-residents are exempt from such additional tax, hence, with respect to non-residents the tax hit on dividends was capped at DDT of 20.56 percent.

The Finance Bill, 2020, has now proposed to revert to taxing dividends in the manner that was prescribed prior to 1997. The burden of payment of tax on dividends has been shifted back to the shareholders and the distributing company would no longer be required to pay DDT. This is a welcome move and would align the taxing regime on dividends in line with international practice.

Foreign companies are subject to tax at an effective rate of about 44 percent on their income. However, according to an existing beneficial provision the dividends for foreign companies would be taxed at a reduced rate of 20 percent (plus surcharge and cess).

Further, the foreign companies would now be able to claim credit for the dividend tax paid by them against their domestic tax liability. That being said, most foreign jurisdictions may not tax dividends at such a high rate and hence there would still be tax leakage for the foreign companies.

Further, foreign companies based in countries with which India has a tax treaty would be entitled to cap the tax payable on dividends earned from an Indian company to the rates prescribed in such treaties.

Usually, the cap on dividends is about 15 percent. Again, such tax would be available as credit against domestic tax liability of these companies in their country of residence.

Accordingly, such entities would welcome the Budget proposal. However, such change may result in a higher tax effect for some; resident individual taxpayers may not be happy either. The increase in surcharge for HNIs had increased the effective income tax rate to about 43 percent for individuals.

With the proposed change, entire amount of dividend may be taxed at such high rates for individuals. The non-resident individuals would be entitled to avail of the reduced rate of 20 percent.

Some relief may be there for sovereign wealth funds that have been granted exemption from dividend income, among other exemptions, in the proposed finance Bill. However, the exemption is only with respect to investments made in specified businesses including entities involved in developing, operating or maintaining infrastructure facilities.

Further, there are other taxes that are similar to DDT, such as tax payable by a company on buy-back of its shares also known as buy-back tax (BBT). BBT is also a liability of the company distributing moneys on buy-back of its shares.

The finance Bill could have streamlined the taxation of the buy-back also with DDT to ensure that tax is payable by the shareholders instead of the company, on buy-back of shares.

While the proposed change in taxation of dividends is a welcome move, the government should have taken measures to ensure that the effective tax burden of the individual shareholders does not increase. After all, dividends are distributed out of profits that have already suffered tax.

-Author is partner, direct tax, at Khaitan & Co