The Dividend Dilemma – Indian HNIs vs Non-Resident Investors

Indruj Rai - 03 February 2020

Under the current regime, dividends distributed by a company are subject to Dividend Distribution Tax (DDT) at an effective rate of 20.56 per cent. Such DDT is levied on the post-tax income of the company i.e. after the company has already suffered corporate tax on its profits. Since DDT is the tax obligation of the distributing company (i.e. it is not in the nature of tax deduction at source), such DDT is not available as a credit to the shareholder.

Dividend so received from the distributing company is exempt from tax in the hands of domestic corporate shareholders and non-resident investors.In the hands of domestic non-corporate shareholders such as individuals, trusts, associations of persons, firms, dividend received in excess of Rs 10 lakhs suffers an additional tax at the rate of 10 per cent (increased by surcharge and cess). Such additional tax is applicable only to resident non corporate shareholders and is not applicable to non-resident shareholders.

There has been a long-standing demand from foreign investors to align the taxing regime for dividends with international practise wherein dividends are taxed in the hands of the distributing company's shareholders. On paying tax directly, the foreign companies would be able to claim credit for taxes paid on dividends in India, against tax liability in their country of residence. This new regime essentially seeks to address such concerns and attract more foreign investment.

From now on dividends will be taxed in the hands of shareholders of the distributing company, which was in practice prior to 1997.

Dividends will now be taxed in the hands of non-residents, including foreign companies, at the rate of 20 per cent (plus surcharge and cess). Such rate would be further reduced where the tax treaty provides for a beneficial rate, the rate of tax on dividend under most tax treaties is 15 per cent. Further, the foreign companies would now be able to claim credit for the dividend tax paid by them against their domestic tax liability.

However, the proposal may be a mixed bag, whereby what is beneficial for the non-resident investors may result in a significant tax outgo in the hands of resident HNIs. The increase in surcharge for HNIs had increased the effective income tax rate to about 43 per cent for individuals. With the proposed change, entire amount of dividend may be taxed at such high rates for resident individuals.

An unintended consequence of the new regime may result in Indian promoters evaluating whether to shift base from India to take benefit of the concessional rate of tax applicable to non-resident individuals. Further, this dichotomy in the rates of tax may lead to companies opting for other options for cash repatriation such as buyback which is still taxed at 20 per cent.

The Finance Bill, 2020 also prescribes amongst other exemptions, exemption from dividend income, for sovereign wealth funds. However, the exemption is only with respect to investments made in specified businesses including entities involved in developing, operating or maintaining infrastructure facilities.

While the proposed change is a welcome move, the government should have taken measures to ensure that there is no dichotomy in the taxation of dividends between resident individuals vs non-resident investors.

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