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TAXABILITY OF DIVIDEND INCOME IN INDIA FROM DOMESTIC COMPANIES FOR INDIVIDUAL EQUITY SHAREHOLDERS

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Abstract: Dividend income has been taxed in India since the inception of the Income Tax Act, 1961 under the head other sources. However, taxation of dividend incomes has seen a turmoil due to the manifold amendments over the years. The manner of taxing dividend has also undergone changes. Earlier, it was taxable in the hands of the recipient shareholders and thereby required the companies to deduct tax at source. And then, it required the domestic companies to pay a dividend distribution tax on declaration, distribution or payment of dividends out of its current or accumulated profits to its shareholders. However, currently it has again been made taxable in the hands of recipient shareholders. This shift would have created havoc for the recipient shareholders as well as the companies distributing its profits to its shareholders.

This paper makes an attempt to review the tax treatment of dividend income from domestic companies on equity shares in the hands of individual shareholders over period commencing from 1997, when corporate taxation in India witnessed major amendments, till 2020 along with the reasons as stated by the then Honourable Finance Minister in his / her Union Budget Speech.

Index Terms - D***ividend, Dividend Distribution Tax, Dividend Tax, Individual, Equity Shareholders.***

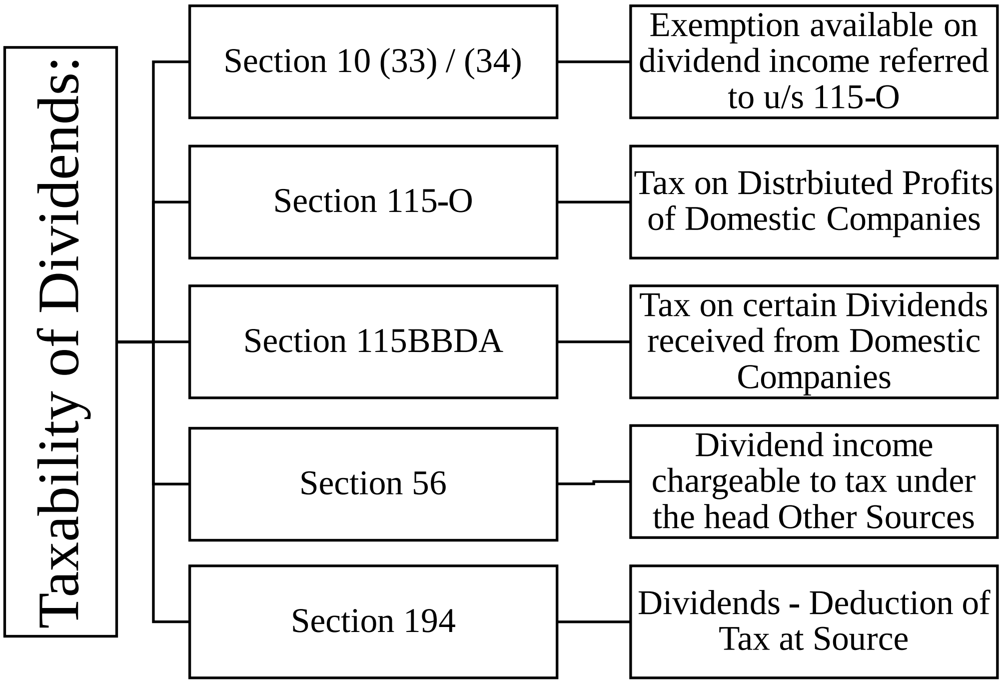
I. INTRODUCTION

Dividend in normal parlance is understood as the distribution of profits by a company to its equity and / or preference shareholders. It has been also referred as a passive income or unearned income as one is not required to put in any efforts to earn it or to work for it. However, one cannot outrun the effort that one needs to put in or at least get an expert advice in order to have a good understanding about the financials of a company to earn a good dividend yield. Due to its easy earning capacity and concern of end-use of distributed of profits, dividend has always been in the spotlight of the lawmakers to tax it. And hence, dividend, in India, has been taxed over the years in different ways.

The definition of 'Dividend' for the purposes of income tax has been specified in the provisions of Section 2 (22) of the Income Tax Act, 1961. Further, dividend income can be taxable in the hands of any category of person as has been defined under section 2 (31) of the Income Tax Act, 1961. For the purposes of the Income Tax Act, 1961, a company is mainly bifurcated into domestic and foreign company and the definitions of each of them has been specified under sections 2 (22A) and 2 (23A) of the Income Tax Act, 1961 respectively.

This study focuses only on the tax treatment of dividends on equity shares received by individual shareholders from domestic companies, specifically for the period beginning from the year 1997 as this was the time when the corporate taxation in India saw major amendments and due to this, taxation on dividends was also affected to a great extent.

The different provisions of the Income Tax Act, 1961 with respect to the taxability of dividend income are as under:



II. Discussion And Analysis

Prior to the year 1997, dividends have been taxed in India since the inception of the Income Tax Act, 1961 as per the provisions of Section 56 of the Income Tax Act, 1961 under the head Income from Other Sources. Further, domestic companies were required to deduct tax at source on the dividend income before distributing it to the shareholders as per the provisions of Section 194 of the Income Tax Act, 1961 at the rates prescribed in Part II of the First Schedule of the Annual Finance Acts. Section 80L of the Income Tax Act, 1961 that dealt with "Deductions in respect of interest on certain securities, dividends, etc." granted deduction, to an extent and subject to some conditions, from the taxable amount of dividend income earned by individual shareholders.

1997: -

Shri P. Chidambaram, the then Honourable Finance Minister, in his budget speech dated February 29, 1997 stated that taxation on dividends had been a vigorous debate and in order to bring an end to this, he proposed to introduce Section 115-O of the Income Tax Act, 1961. He mentioned that there were few companies that distributed excessive dividends wherein preferably they ought to retain such profits and invest them for their future growth. This section was introduced in order to reward the companies that ploughed back their profits for long-term strategic growth.

The Finance Act, 1997, w.e.f. June 1, 1997 prominently removed the applicability of Section 194 due to the insertion of Section 115-O of the Income Tax Act, 1961 and hence, no deduction of tax at source was required to be made in respect of dividends as referred to under section 115-O of the Income Tax Act, 1961.

Further, The Finance Act, 1997, w.e.f. June 1, 1997 introduced Chapter XII-D of the Income Tax Act, 1961 that deals with 'Special Provisions relating to tax on distributed profits of domestic companies' since its introduction. Sections 115-O to 115Q of the Income Tax Act, 1961 were also introduced as a part of this chapter. Section 115-O of the Income Tax Act, 1961, since its inception, deals with "Tax of distributed profits of domestic companies". This newly inserted section required the domestic companies to pay Dividend Distribution Tax (hereinafter referred to as DDT) @ 10% on the dividends declared, distributed or paid by them to shareholders out of accumulated or current profits. As a result, dividend income was exempted in the hands of individual shareholders by virtue introduction of Section 10 (33) of the Income Tax Act, 1961 which was also introduced by the Finance Act, 1997 w.e.f. April 1, 1998. However, the benefit of deduction available under section 80L of the Income Tax Act, 1961 was removed with effect from April 1, 1998 by The Finance Act, 1997.

2000: -

The Finance Act, 2000, w.e.f. June 1, 2000, amended the provisions of Section 115-O of the Income Tax Act, 1961 and doubled the rate of DDT from 10% to 20%. Shri Yashwant Sinha, the then Honourable Finance Minister, in his budget speech dated February 29, 2000 stated that in order to mitigate the huge gap of tax rates on interest and dividends and to overcome the criticism faced due to it, he proposed to increase the DDT rates.

2001: -

Section 115-O of the Income Tax Act, 1961 was again amended to alter the DDT rate and this time it was brought down to 10% again by The Finance Act, 2001, w.e.f. June 1, 2001. And this time, Shri Yashwant Sinha, the then Honourable Finance Minister, in his budget speech dated February 28, 2001 mentioned that this step was undertaken to provide an impetus to the capital market in our country.

2002: -

The Finance Act, 2002, w.e.f. April 1, 2003, one more time amended provisions of Section 115-O of the Income Tax Act, 1961 and abolished the applicability of this section from the financial year commencing from April 1, 2002. Shri Yashwant Sinha, the then Honourable Finance Minister, in his budget speech dated February 28, 2002 stated that the problem of taxation on dividends had been troubling him over his tenure as the Finance Minister and finally he was convinced that the existing system of dividend taxation must be abolished. So he removed the exemption available on dividend income and made it taxable in the hands of the recipient shareholders at the income tax rates applicable to them with the removal of Section 115-O of the Income Tax Act, 1961. He felt that the present system of dividend taxation led to inequality as it allowed the taxpayers in the higher tax brackets to avail an exemption on the dividend income earned by them and tax on such dividend charged @ 10% only as per the provisions of Section 115-O of the Income Tax Act, 1961.

He also proposed to reinstate the deduction of tax at source on such dividend income @ 10% as per the provisions of Section 194 of the Income Tax Act, 1961. Thus, The Finance Act, 2002, w.e.f. June 1, 2002 brought back the applicability of this section with the removal of Section 115-O of the Income Tax Act, 1961 and required deduction of tax at source on dividend income in excess of Rs. 1,000. The provisions of Section 80L of the Income Tax Act, 1961 were also reinstated permitting deduction upto an amount of Rs. 9,000 on the amount of dividend income earned by an individual subject to fulfilment of the conditions prescribed in that section.

2003: -

In the budget speech dated February 28, 2003, Shri Jaswant Singh, the then Honourable Finance Minister of India mentioned that in order to encourage investment in the industrial sector, to improve equity and debt markets and to bring retail investors back to the capital markets by reinstating their confidence, he proposed to exempt dividends in the hands of the shareholders by introducing Section 10 (34) of the Income Tax Act, 1961 and reinstating the provisions of Section 115-O of the Income Tax Act, 1961. Thus, The Finance Act, 2003, w.e.f. April 1, 2003 reinforced the provisions of this section and required domestic companies to pay DDT @ 12.50% on the amount of dividends declared, distributed or paid out of its accumulated or current profits.

With the reinforcement of Section 115-O of the Income Tax Act, 1961, Section 10 (34) of the Income Tax Act, 1961 was inserted by the Finance Act, 2003 w.e.f. April 1, 2004 and it again exempted dividends as referred to under section 115-O of the Income Tax Act, 1961.

The existence of Section 194 of the Income Tax Act, 1961 was short-lived as Section 115-O was reinstated by The Finance Act, 2003 and as a result, this section was removed from the limelight and no deduction of tax at source on dividend income was required to be made in respect of dividends as referred to under section 115-O of the Income Tax Act, 1961. The Finance Act, 2003, w.e.f. April 1, 2004 amended the provisions of Section 80L of the Income Tax Act, 1961, thereby removing the benefit deduction available from dividend income received by an individual shareholder.

2007: -

The Finance Act, 2007, w.e.f. April 1, 2007, amended the provisions of Section 115-O of the Income Tax Act, 1961 and increased the rate of DDT from 12.50% to 15%. The then Honourable Finance Minister, Shri P. Chidambaram, in his budget speech dated February 28, 2007 stated that based upon the ability to pay and in order to improve vertical equity, he proposed to increase the DDT rate.

2014: -

The Finance (No. 2) Act, 2014 w.e.f. October 1, 2014, amended the provisions of Section 115-O of the Income Tax Act, 1961 that required to compute the DDT on gross amount of dividend declared rather than on the amount of dividend net of taxes.

This suggestion was made by Shri Arun Jaitley, the then Honourable Finance Minister, in his budget speech dated July 10, 2014 wherein he stated that inconsistency prevailed in the taxation of dividends as the shareholder was required to pay income tax on gross amount of dividend received while the domestic companies were making payment of DDT on the amount of dividend net of taxes. This suggestion would help in eliminating the said inconsistency. Thus, the companies were required to undergo revised calculations for DDT amount as is explained with the illustration given below:

Pre Amendment: -	**Post Amendment: -**
Dividend Declared = Rs. 500	Dividend Declared = Rs. 500
DDT Computation: - DDT @ 15% of Rs. 500 = Rs. 75 + Surcharge and Cess, as applicable	DDT Computation: - Now Rs. 500 is considered as the amount of dividend net of taxes, meaning thereby, amount of dividend after deducting DDT @ 15%. Hence, Rs. 500 is the amount at 85%. DDT of 15% has to be applicable on the gross amount of dividend declared i.e., 100% and not the net amount i.e., 85%. Hence, the first step is to convert the amount of dividend net of taxes to gross amount: Rs. 500 / (100-15%) = Rs. 588 approximately Now, the second step is to compute DDT on this gross amount of dividend: DDT @ 15% of Rs. 588 = Rs. 88 approximately + Surcharge and Cess, as applicable

2016: -

The Finance Act, 2016, w.e.f. April 1, 2017 inserted Section 115BBDA of the Income Tax Act, 1961 that deals with "Tax on certain dividends received from domestic companies" since then.

The then Honourable Finance Minister, Shri Arun Jaitley, in his budget speech dated February 29, 2016 mentioned that the existing system of taxation on dividend uniformly applied in case of all investors irrespective of their income and tax rates applicable to them. As a result of this, the fairness and progressivity of taxes was distorted. He further stated that persons with relatively higher income could bear the higher burden of taxes and so he proposed to introduce tax in the hands of recipient shareholders, over and above DDT, by introduction of Section 115BBDA of the Income Tax Act, 1961.

This newly inserted section required the recipient individual shareholders earning aggregate dividends during a financial year from domestic companies above Rs. 10 lakhs to pay an income tax @ 10% on such excess dividend amount. However, this section was not applicable in case of deemed dividend as explained under section 2 (22) (e) of the Income Tax Act, 1961.

Section 10 (34) of the Income Tax Act, 1961 was also amended by the Finance Act, 2016, w.e.f. April 1, 2017 with the introduction of Section 115BBDA of the Income Tax Act, 1961. The implication of this amendment was that the dividend income referred to under section 115-O of the Income Tax Act, 1961 was exempted upto Rs. 10 lakhs by virtue of Section 10 (34) of the Income Tax Act, 1961 while any such dividend income above Rs. 10 lakhs was chargeable to tax @ 10% as per the provisions of Section 115BBDA of the Income Tax Act, 1961.

2020: -

The Finance Act, 2020, w.e.f. April 1, 2021 removed the applicability of Section 115-O of the Income Tax Act, 1961 on the dividends declared, distributed or paid after March 31, 2020. Shrimati Nirmala Sitharaman, the Honourable Finance Minister, in her budget speech dated February 1, 2020 mentioned that the levy of DDT increased the burden of taxpayers falling in the lower tax brackets. She also stated that foreign investors were not able to take the credit of DDT in their respective home countries and it reduced their yield on equity investment in India. Hence, to increase the appeal of the equity market in India and to provide some respite to a major portion of investors, she proposed to abolish this section and introduced taxation of dividends in the hands of shareholders as per the tax rates applicable to them. Further, in her budget speech she stated that she proposed to move back to the conventional system of taxing dividends and deduction of tax thereon as per the provisions of Section 194 of the Income Tax Act, 1961.

Hence, dividend income is now taxable in the hands of the recipient shareholders as per the income tax slabs applicable to them. As a consequence of this amendment, the provisions of Section 10 (34) of the Income Tax Act, 1961 have been amended and the exemption on dividend income has been withdrawn as well as the provisions of Section 115BBDA also have been amendment and the applicability of the section has been restricted till March 31, 2020. Thus, the income tax @ 10% on aggregate dividends as referred to under section 115-O of the Income Tax Act, 1961 received from domestic company / companies above Rs. 10 lakhs would be applicable on such dividends received upto March 31, 2020 and from the financial year commencing from April 1, 2020, dividends shall be taxable in the hands of recipient shareholders as per the income tax slabs applicable to them.

It is by virtue of The Finance Act, 2020, w.e.f. April 1, 2021 that this section has come back to its original state and tax deduction at source on dividends is now required to be made @ 10% by the companies as per the provisions of Section 194 of the Income Tax Act, 1961. However, no tax is required to be deducted on dividend if such payments are made in any mode other than cash and the amount of aggregate dividends to be paid to the shareholder does not exceed Rs. 5,000.

The following flowchart highlights the gist of the journey on taxation of dividend from domestic companies in the hands of individual equity shareholders for a period from 1997 to 2020:

1997:

- Section 115-O: Domestic Company required to pay DDT @ 10%.
- Section 10 (33): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2000:

- Section 115-O: Domestic Company required to pay DDT @ 20%.
- Section 10 (33): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2001:

- Section 115-O: Domestic Company required to pay DDT @ 10%.
- Section 10 (33): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2002:

- Section 194: Domestic Company required to deduct tax at source @ 10% on dividend above Rs. 1,000.
- Section 56: Dividend Income from Domestic Companies taxable in the hands of individual shareholders as per income tax slabs.
- Section 80L: Deduction on dividend income upto Rs. 9,000 available to individual shareholders.

2003:

- Section 115-O: Domestic Company required to pay DDT @ 12.50%.
- Section 10 (34): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2007:

- Section 115-O: Domestic Company required to pay DDT @ 15%.
- Section 10 (34): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2014:

- Section 115-O: Domestic Company required to pay DDT @ 15% on gross amount of dividend.
- Section 10 (34): Dividend Income from Domestic Companies exempted in the hands of individual shareholders.

2016:

- Section 115-O: Domestic Company required to pay DDT @ 15% on gross amount of dividend.
- Section 10 (34): Dividend Income from Domestic Companies exempted in the hands of individual shareholders upto Rs. 10 Lakhs.
- Section 115BBDA: Dividend Income from Domestic Companies taxable @ 10% above Rs. 10 Lakhs taxable in the hands of individual shareholders.

2020:

- Section 194: Domestic Company required to deduct tax at source @ 10% on dividend above Rs. 5,000.
- Section 56: Dividend Income from Domestic Companies taxable in the hands of individual shareholders as per income tax slabs.

III. Research Methodology

Data and Sources of Data:

This study has been undertaken only on secondary data wherein major portion of the data has been obtained from the Income Tax Act, 1961, Union Budget Speeches of the Honourable Finance Ministers and the Annual Finance Acts from time to time.

Tools and Techniques:

This study is qualitative in nature and the technique used to collect the data has been purely based on the review of the relevant statutes and documents.

IV. Commentary

An issue that needs to be pondered upon is the economic double taxation that persists in case of dividend taxation. Dividend is nothing but distribution of profits by a company to its shareholders. Why are we taxing distribution of profits per se? Even partnership firms share their profits with their partners. However, the share of profits that is received by a partner from the partnership firm is exempt under section 10 (2A) of the Income Tax Act, 1961 in his / her hands as it has already been taxed in the hands of the partnership firm. Same is the case of companies when it distributes its profits to its shareholders. These profits have already been charged to tax in the hands of companies first. Then why are either companies or recipient shareholders required to pay tax on dividend?

Currently, as the recipient shareholder is required to pay tax on dividend as per his / her income tax slab, the same amount is taxed twice in different hands by levying taxes with different names as company is paying corporate tax on its income and shareholder is paying income tax on its dividend income. At the time of existence of Section 115BBDA, the situation was even worsened off as the same amount was taxed thrice as the companies paid taxes on its profits, DDT was to be paid by them and shareholders having dividend income above Rs. 10 lakhs also were required to pay income tax on such income.

If the intention of the existing government was to protect the interest of the taxpayers falling in the lower tax brackets due to the increased levy of DDT on dividend income, as stated by the Honourable Finance Minister, Shrimati Nirmala Sitharaman in her budget speech of February 1, 2020, they should have actually exempted the dividend income in the hands of such shareholders as it already leads to economic double-taxation. On one side the government is bringing down corporate tax rates but that should not be compensated at the cost of individual taxpayers by shifting more burden of tax upon them.

V. Conclusion

Based on the applicability of various provisions for taxation of dividends, it is clearly seen its taxation has been like a roller-coaster ride. This is mainly due to the shift in its taxation system from conventional to indirect, then bringing it back to conventional system. Isn't it a mockery of the taxation system that the ball at times was put in the court of recipient shareholders for payment of tax on dividends and sometimes in the court of companies? Was this due to the lack of foresight of the government or was government trying to tax on trial basis checking which system works better?

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