TAXMANN®

www.taxmann.com
• Income-Tax • GST • International Taxation • Transfer Pricing
• FEMA & Banking • Competition Laws • Company & SEBI Laws
• IBC • Accounts & Audit • Indian Acts & Rules

India’s return to classical dividend taxation – Panacea Pill or not?

Gouri Puri

Partner, Shardul Amarchand Mangaldas & Co.

Nimish Malpani

Associate, Shardul Amarchand Mangaldas & Co.

Introduction

In a historic move, Union Budget, 2020 marked Indian's return from the dividend distribution tax (DDT) regime to the classical system of dividend taxation. The tax shift was obvious – going forward, shareholders would pay tax on dividends instead of the distributing company. While many taxpayers rejoiced, a deeper dive revealed that the policy shift came with a new set of problems. In this article, we reflect on the key issues that surround India's new dividend tax system ahead of the budget.

Historical underpinnings

The rationale to introduce DDT was two-fold. First, the Government sought to encourage companies to plough back profits instead of distributing them to its shareholders. Second, the Government wanted to ensure that dividend income did not escape taxation. It was easier to recover taxes from the companies distributing dividends, instead of chasing shareholders. However, this was during an era where computer assisted processing of information and electronic matching of records was not prevalent.

In 2020, with the increased accessibility to taxpayer information, the Government was plausibly more open to recovering taxes and enforcing compliance from shareholders. Consequently, policymakers gave into the demand of returning to the classical way of dividend taxation.

This is more so because while DDT solved the issue of compliance and reporting, it gave rise to other acute issues. A flat tax of 20.56% on the dividend income was not progressive and prejudicial to tax payers who belonged to a lower tax bracket. Instead, DDT was advantageous for taxpayers whose marginal tax rate was higher than the DDT. Foreign shareholders also suffered as they could not claim foreign tax credit against such

DDT and there was ambiguity on whether beneficial withholding rates under Tax Treaties (DTAA) could be availed instead of paying DDT on 20.56%. While a recent case law[1] ruled that the beneficial rate of tax on dividend under DTAA should prevail over the DDT, the market view on this issue remains divided.

The re-introduction of classical system of dividend taxation has solved both issues. However, like every policy change, the introduction of the classical system of dividend taxation, comes with its own set of problems.

Classical dividend tax system – key issues

Distortionary impact on cash repatriation mechanics and form of entity: For the resident HNI taxpayers, the effective tax rate on dividend income has surged from a flat 20.56% (plus an additional 10%, excluding surcharge and cess, for dividend received north of INR 10 lacs) to as high 35.88% (regardless of quantum of dividend income). Consequently, return to the classical dividend tax system has significantly decreased after-tax income of resident HNI shareholders, making the corporate form expensive. The high tax rate for HNIs is also attributable to increase in surcharge rate over the last few years.

There have been two key fallouts of this shift. First, promoters are exploring more tax efficient cash repatriation options such as buy back of shares, service fee, interest, etc. Second, there is a shift towards the setting up of LLPs that are taxed at higher rates but distribution of profits are exempt.

The Government could consider a flat special dividend tax rate of all individual shareholders at 20% (akin to DDT) to mitigate such tax distortions. A lower tax may also result in higher compliance by shareholders.

Disparity in taxation between residents and non-residents: The tax rate on dividends earned by non-residents has been capped at 20% (plus applicable surcharge and cess). Further, DTAAs usually provide for a beneficial tax-withholding rate ranging between 5-15%. Resultantly, most resident investors, especially HNIs result in paying much higher taxes then their foreign counterparts on the same dividend income. Such tax disparity incentivizes round tripping structures and change in tax residency status.

For such reason also, the Government could consider a flat special dividend tax rate of all individual shareholders at 20% (at parity with non-residents) to mitigate such tax distortions

Subjectivity involved in DTAA claims: Indian companies will be required to withhold taxes on dividends paid to non-resident shareholders. Considering that, most DTAAs provide a more beneficial tax rate; Indian companies will have to go into treaty eligibility claims of every non-resident shareholder. This includes evaluating such treaty claim in light of beneficial ownership tests, meeting principal purpose test, minimum holding period and GAAR. Directing shareholders to obtain a withholding tax certificate may not practicable each time. All of this has subjectivity involved and the distributing company may have to either assume a litigation risk or conservatively withhold tax at 20% (plus applicable surcharge and cess) under domestic law. The Government could consider providing some objective bright line tests for extending tax treaty benefits or mitigate the rigours of penalty exposure.

Restrictions on expenditure deductibility: Another issue is that the Income-tax Act, 1961 ("Act") prohibits any deduction other than interest expenditure against dividend income. Further, the deduction because of interest expenditure is restricted to 20 per cent of dividend income of a resident shareholder (Section 57 of the Act). This poses as a problem for highly leveraged investors and investment companies that spend a substantial chunk of their resources in researching, managing and tracking their investments. On the other hand, such cap on expenditure may not apply if dividend income is classified under the head business income (the downside would be that the shares could take the character of a trading asset). For resident shareholders, given that dividend income is taxed at the regular tax rates, bona-fide expenditure claims even (other than interest) should be allowed and the cap on interest expense should be removed.

Other issues: To remove the cascading effect of taxation in a multi-tier holding structure, a rollover benefit for dividend income is permitted under section 80M of the Act, provided dividend received by an intermediate holding company is repatriated to its shareholders within a specified timeframe of one month prior to the return filing date. While this partially plugs the issue of double taxation, many companies may not be able to repatriate dividends within such specified timeframe. Further, the interplay of section 57 with section 80M is unclear – whether deduction under section 80M is to given on a gross basis or on a net basis (after deducting interest expenditure).

Conclusion

There is little doubt that each system has its advantages and drawbacks. Moreover, it is difficult to keep everyone happy. Yet, there is a lot more room to streamline and rationalize the new dividend taxation system and address its problems. It is hoped that the Government will consider these issues while announcing Union Budget, 2021.

The views expressed by the authors are personal and does not represent of the Firm.

■■

---

1. *Giesecke & Devrient [India] (P.) Ltd.* v. *Addl. CIT* [2020] 120 taxmann.com 338 (Delhi - Trib.).