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Does your dividend income need to be taxed thrice?

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NEW DELHI: If you attend any annual general meeting, inevitably you will find a shareholder standing up and demanding her fair share of dividend. While capital appreciation is one of the primary reasons why people seek to invest in equity, dividend income is always welcome.

The sweetness, however, is blunted to some extent by the triple levy of tax on the dividend. Dividend is a distribution of 'after tax' profit of a company and the tax paid by the company is the first level of tax that dividend bears. Dividend Distribution Tax (DDT) is the second levy and the recently introduced 'Super Rich Dividend Tax' is the third. Shareholders earning dividend income of Rs 10 lakh or more have to bear a tax of 10% on such income. Thus, it comes as no surprise that both shareholders and companies are hoping for abolition of DDT.

THE DIVIDEND CASE	WITH DDT		IF DDT IS NIXED	
Particulars	X	Y	X	Y
Profit of the company	100	100	100	100
Less: Corporate income-tax at the rate of 25.17% (lower tax of 22% + surcharge and cess)	25.17	25.17	25.17	25.17
Distributable profit	74.83	74.83	74.83	74.83
Less: DDT at 20.55%	12.76	12.76	–	–
Amount of dividend declared	62.07	62.07	74.83	74.83
TAX IN THE HANDS OF THE SHAREHOLDERS				
Current scenario: Tax on dividend income of < 10 lakh at 14.248% (10% + surcharge of 37% + cess of 4%)	NA	8.84		
Scenario when DDT is abolished: Dividend is taxed at regular rates in hands of shareholders (30% + surcharge of 37% + cess of 10%)	–	–	NA	31.98
Disposable income in the hands of the shareholder	**62.07**	**53.23**	**74.83**	**42.85**
Total tax outgo	37.93	46.77	25.17	57.15

Note: It is assumed that the entire dividend is distributed to X and Y. As can be seen from the computation, abolition of DDT will help small shareholders, whereas the impact for large shareholders **will be adverse**

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There are other challenges, too, for shareholders. If any expenditure is incurred in earning tax-free income, like dividend — say interest on borrowed funds for investments in equity, based on a formula, such expenditure is disallowed in the hands of the shareholder, as per the provisions of section 14A.

Dividend, no matter the quantum, is tax-free in the hands of foreign shareholders. However, in most cases (unless the investment is structured via a few favourable countries such as Mauritius), investors cannot claim credit in their home country on the underlying tax — DDT.

The triple whammy impact and a future scenario where DDT is abolished are explained by this illustration and the accompanying graphic: X is a small shareholder and has total income of less than Rs 5 lakh. In short, he does not bear any tax liability.

Y earns dividend income of more than Rs 10 lakh and has total income of more than Rs 5 crore.

In computing the scenario where DDT is abolished, it is presumed that the dividend income will be taxable in the hands of all shareholders at the applicable income-tax rates. While Budget 2020-21 may change the tax slabs/rates, the illustration uses the existing rates.

Today, no country in the world has a DDT regime. While South Africa had introduced such a regime it was later abolished. Historically, in India, dividend has been taxed in the hands of shareholders and it was only in 1997 that DDT was introduced in the income-tax law. Interestingly, DDT was scrapped in 2002 only to be re-introduced in the next year on grounds of ease of tax administration.

Finance minister Nirmala Sitharaman has publicly termed DDT as regressive. Ideally, the DDT regime should be replaced by the classical system of taxing dividends in the hands of the shareholders. However, as seen in our illustration, given the high rate of surcharge of 37% in the hands of the super-rich, a concessional rate for taxing dividend income should be introduced.

If this is done, it will not only help domestic shareholders, but also attract foreign investors who will get a foreign tax credit on the regular tax paid by them and not face the challenges relating to non-credit of DDT.