TAX ON DIVIDEND

The Ever-changing provision of Tax

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Chapter 1 Introduction:

One of the most talked amendment of Finance Act, 2020, was removal of dividend distribution tax. Honourable Finance Minister Shri Nirmala Sitharaman stated in her budget speech-

"Currently, companies are required to pay Dividend Distribution Tax (DDT) on the dividend paid to its shareholders at the rate of 15% plus applicable surcharge and cess in addition to the tax payable by the company on its profits.

It has been argued that the system of levying DDT results in increase in tax burden for investors and especially those who are liable to pay tax less than the rate of DDT if the dividend income is included in their income.

Further, non-availability of credit of DDT to most of the foreign investors in their home country results in reduction of rate of return on equity capital for them. In order to increase the attractiveness of the Indian Equity Market and to provide relief to a large class of investors, I propose to remove the DDT and adopt the classical system of dividend taxation under which the companies would not be required to pay DDT. The dividend shall be taxed only in the hands of the recipients at their applicable rate.

Further, in order to remove the cascading effect, I also propose to allow deduction for the dividend received by holding company from its subsidiary. The removal of DDT will lead to estimated annual revenue forgone of ₹25,000 Crore.

This is another bold move which will further make India an attractive destination for investment."

When abolition of DDT was announced in her budget speech, the initial feeling among all was of euphoria as it seemed to be a much awaited amendment in the Income Tax Act. The amendment which government feels will lead to heavy reduction in its annual revenue, the amendment which will make India a more attractive investment destination and many more facts.

But wait, a series of questions raise in my mind like, 'Why was it removed?', 'Was this the first time when it was removed?', 'What are its pros and cons?', 'When was it introduced?', etc. A bulk of questions are to be answered. So let us begin from the start, a trek across the terrain of Dividend Taxation.

But before learning about taxation of dividend, let us first understand about a few basic concepts and then get on to our main topic.

Chapter 2 What is Dividend?

Dividend in simple terms means distribution of profits earned by a company to its shareholders. It may be distributed in the form of cash payments, stocks, debentures, etc. but the most common among all is cash payments.

Now let us discuss the definition of Dividend provided by various statutes.

Income Tax Act, 1961

As per the provisions of Income Tax Act, 1961 **any distribution whether in the form of direct payments, debentures, stocks, deposit certificates, bonus, etc. out of the accumulated profits of the company is a Dividend**. The definition of the IT Act is wide enough to **include payments that are to be deemed as dividend** in the hands of beneficial owner, although primarily they are not dividends. **(sec. 2(22))**

'Deemed Dividend' as per Income Tax Act includes any payment by way of loan or advance, made by the company in which public are not substantially interested, to the extent of its accumulated profits, to

- an equity shareholder (being beneficial shareholder) having voting power higher than 10%, or
- to a concern where the above mentioned shareholder is having substantial interest and is a member or partner of the concern, or
- any payment on behalf or for the individual benefit of such shareholder.

Companies Act, 2013

As per the provisions of Companies Act, 2013, 'Dividend' is defined as **dividend includes interim dividend**. This definition of dividend is inclusive in nature and does not describes much about what is to be considered as dividend. **(sec. 2(35))**

According to the guidelines issued by ICSI, as definition of dividend as per Companies Act is of inclusive nature, dividend is to be understood as per general understanding that the profits of the company that are not retained by the company in the business and are distributed to the shareholders in proportion to the amount paid-up on the shares held by them, are dividends.

Dividends are usually paid by the company after declaration at the AGM, but sometimes the Board of the company pays dividend between two AGM's, this dividend is known as 'Interim Dividend'.

Having discussed about definition of dividends as per above mentioned acts, now let us analyze whether following are considered as dividend or not.

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Are Bonus / Right shares to be treated as dividends?

To answer the above question it is to be seen that whether it is an equity shareholder or a preference shareholder who is receiving these shares from the company.

If an **Equity shareholder** receives bonus shares, the same is not treated as dividend income because it is mere capitalisation of profits in the books of the company and no asset is disbursed on account of the same. Also for the shareholder there is no actual receipt rather only shares are received and also the market value of the aggregate shares remains unchanged, as, per share value reduces in same proportion. Similarly, if right shares are issued by the company there is no substantial increase in assets of the shareholders and therefore the same cannot be deemed to be dividend income in the hands of the assessee. Reference can also be made to *'Secretarial Standard on Dividend (SS-3)'* which clarifies that capitalisation of profits is not dividend.

But in case bonus shares are received by a **preference shareholder**, they will be treated as dividend income and will be liable to all the taxation provisions of dividends. This is so because preference shareholders are not participative in nature i.e. are not entitled to share profits apart from a fixed percentage and therefore it is received by them in excess of their right. Also, it leads to creation of extra liability in the books of the company and thus, is treated as dividend in the hands of shareholders. Similarly, in case of preference shareholders receiving right shares it is treated as dividend income because the same is an extra benefit to the shareholder and leads to increase in liability of company.

Apart from this, there have been various arguments to include bonus issue and right issue received by Equity Shareholders in income from other sources under section 56 of the IT Act, but in that case too, reference can be made to *Supreme Court ruling in case of Khoday Distilleriers Ltd. Vs CIT (2008) [308 ITR 312]* and various others which restrict those sections from taxing this as income under section 56 of the IT Act.

Supreme court has also been of the view that issue of Bonus / Right shares does not lead to a substantial increase in the asset of the shareholder and therefore should not be taxed as other income in the hands of the shareholder.

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Chapter 3 The journey of Dividend Taxation

Before Income Tax Act, 1961:

Dividend taxation policy in India has been a dynamic one. Till F.Y. 1958-59 dividend taxation was based on tax imputation method i.e. shareholder was given credit of the taxes paid by the company on its earnings, effectively corporate earnings were taxed only once i.e. when they were earned by the company and if dividend was declared, credit of tax paid by company could be taken by shareholder like a credit of TDS. However, the major disadvantage of this method was that, the assessment of shareholder could be done only after the assessment of Company so as to know the true liability of the assessee, also due to various tax incentives given to the company, computing of credit to be given to shareholder became complicated. Hence, it led to both inefficient tax collection and hard administrative challenges to perform assessments.

In order to overcome these shortcomings, the above method of single taxation was abolished in the F.Y. 1959-60 and corporate earnings were made liable to taxation twice i.e. Tax on Corporate Earnings in the hands of Company and then Dividends as income in the hands of the shareholders. This was also considered to be in line with the understanding that company is a separate legal entity, hence its earnings are to be taxed separately from that of shareholder.

Introduction of Income Tax Act, 1961:

During the year 1961, when the IT Act, 1961 was introduced, in this act too, dividend income was taxed in line with the revised policy as per F.Y. 1959-60 i.e. apart from corporate taxes on the company's earnings, dividend distributed was taxed in the hands of the assessee.

In order to increase efficiency in collection of taxes, the Act further required companies to deduct TDS u/s. 194 at specified rates in case of person receiving dividend in excess of ₹2,500/-.

This method of Dividend Taxation also known as classical method these days, was the longest surviving provision of dividend taxation, till it was amended in the year 1997.

Finance Act, 1997:

With the introduction of Liberalisation, Privatisation and Globalisation (LPG) policy in the year 1991, Indian Economy started sharing the global economic boom with foreign institutional investors flooding in from all sides. The GDP growth averaged 7.5% p.a. until the economy was hit by the Asian Financial Crisis. Industrial growth crashed, foreign investment got reduced, the GDP growth rate dropped down to 5.5%, etc. With the economy in trouble from all sides only investment could have saved the economy.

The core focus of Government of India was to retaining the earnings of the company in company itself and reinvesting it so as to boost the economy through these investments, not only then but even before the crisis.

So in order to promote ploughing back of profits by the company, the then Finance Minister P. Chidambaram in his budget speech of Union Budget 1997 on 28th February, 1997 announced,

"Another area of vigorous debate over many years relates to the issue of tax on dividends. I wish to end this debate. Hence, I propose to abolish tax on dividends in the hands of the shareholder.

Some companies distribute exorbitant dividends. Ideally, they should retain bulk of their profits and plough them into fresh investments. I intend to reward companies who invest in future growth. Hence, I propose to levy a tax on distributed profits at the moderate rate of 10 per cent on the amount so distributed. This tax shall be incidence on the company and shall not be passed on the shareholder."

Thus, marking the birth of Dividend Distribution Tax (DDT) in India. It was the first time when Tax was levied on the Company distributing Dividends, while the receiver of dividend would receive it as a tax free income.

Tax @ 10% was levied u/s. 115O of the Act on the company, over and above the corporate tax on the dividend declared and the same was made a tax free income for the receiver u/s. 10(33) of the Act.

Further, in order to justify the move, the memorandum to the Finance Act, 1997 stated that the existing tax collection system was very cumbersome and involved a lot of paper work as the Company paying dividends was supposed to deduct TDS and then issue TDS certificates to the shareholders. They would then either pay more tax or claim credit of TDS in their return. In case of few shareholders TDS was to be refunded as they were below taxable limit. Thus, in order to overcome all of this, the existing system has been abolished.

Finance Act, 2002:

The newly introduced provision of DDT continued for a while, before it was changed for a sole year in 2002 to the classical method of taxing it in the hands of the assessee.

This reversal to the classical method was done to address the inequality caused by uniform treatment of dividends earned by corporates, high net worth individuals and small shareholders having low annual income. However, this brought back with itself all the compliance related issues and the Government was quick enough to shift back to the system of DDT in the year 2003.

Finance Act, 2003:

As the government decided to reinstate the provisions of DDT, section 115O was revived with effect from 01.04.2003 for taxing the dividend declared by the company @ 12.5% and section 10(34) made it tax free in the hands of the shareholder.

Thereafter, several significant amendments were made to these provisions, from time to time.

Finance Act, 2007:

First major amendment post re-introduction of DDT was made in section 115O to increase the rate of tax on dividends to 15%.

Finance Act, 2014:

A significant amendment was made by addition of provision of grossing up of dividends while taxing them under DDT.

Now let us understand what does grossing up of dividend means with help of an example.

Particulars	**Before Finance Act, 2014**	**After Finance Act, 2014**
Net Dividend Declared	₹100	₹100
DDT rate	15%	15%
Tax Payable by company	₹15 [100 x 15%]	₹17.65 [₹100 / (100-15)% - ₹100]
Actual receipt by shareholder	₹100	₹100

(*hypothetical example surcharge and cess not considered)

This provision thereby increases the income of shareholder with the amount of tax borne by the company on its behalf and increases the tax liability. However, net dividend received by the shareholder remains the same.

Finance Act, 2016:

Section 115BBDA introduced in the IT Act for taxing dividends received (other than deemed dividend) in excess of ₹10,00,000/- by an individual / HUF / Firm at an additional rate of 10%, payable by the recipient itself.

What government noticed was that the effective rate of DDT was 20.56% including the applicable surcharge and cess, and in case of an individual / HUF receiving dividend in excess of ₹10,00,000/- were not supposed to pay anything as dividend income was exempt, but as per their tax slab it should be taxed at 30%. So in order to tax dividend in line with the slab rate government introduced an additional tax @ 10%. And as in

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case of Firms too the rate of tax was 30% government levied an additional tax on them too.

Finance Act, 2018:

Deemed Dividend made taxable u/s. 115O of the Act, at the rate of 30%. This change was brought in order to curb various issues caused due to taxing of such dividend in the hands of recipient. The memorandum of the said budget stated-

'At present dividend distributed by a domestic company is subject to dividend distribution tax payable by such company. However, deemed dividend under sub-clause (e) of clause (22) of section of 2 the Act is taxed in the hands of the recipient at the applicable marginal rate. The taxability of deemed dividend in the hands of recipient has posed serious problem of the collection of the tax liability and has also been the subject matter of extensive litigation.

With a view to bringing clarity and certainty in the taxation of deemed dividends, it is proposed to delete the Explanation to Chapter XII-D occurring after section 115Q of the Act so as to bring deemed dividends also under the scope of dividend distribution tax under section 115-O. Further, such deemed dividend is proposed to be taxed at the rate of 30 per cent. (without grossing up) in order to prevent camouflaging dividend in various ways such as loans and advances.

This amendment relating to imposition of dividend distribution tax on deemed dividend will apply to transactions referred to in sub-clause (e) of clause (22) of section 2 of the Act undertaken on or after 1st April, 2018.'

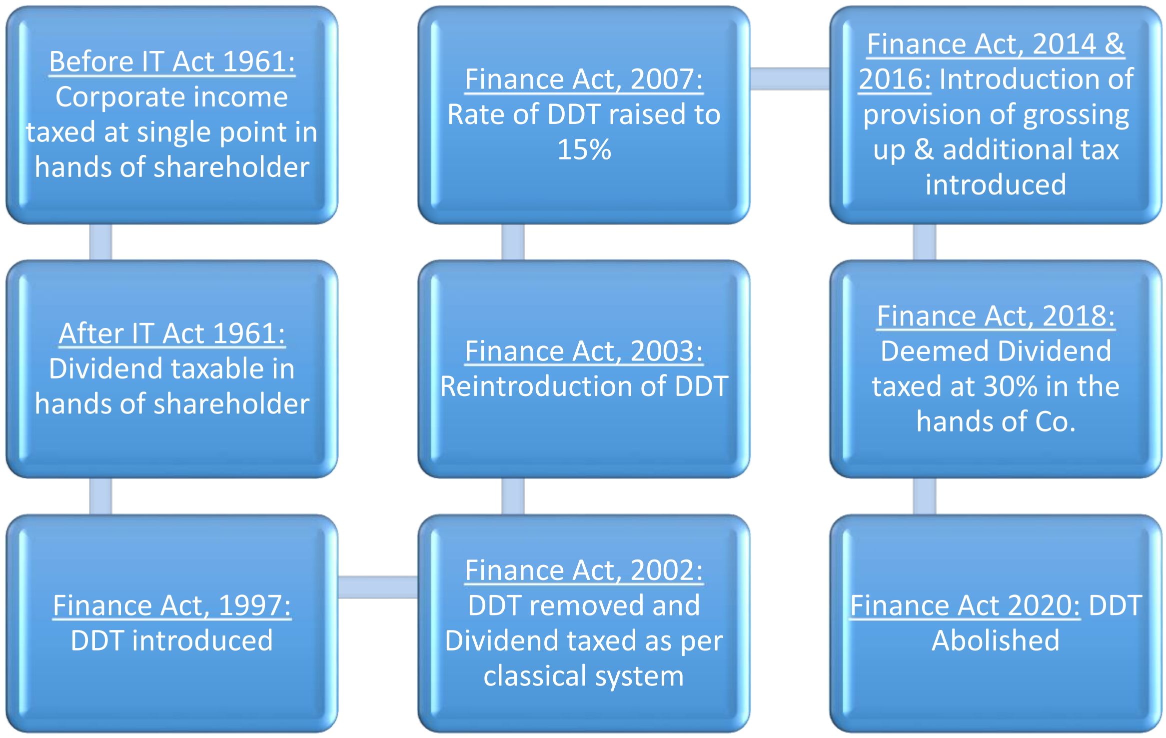
These issues have been discussed in detail under the chapter of deemed dividend.

Finance Act, 2020:

And finally now again this provision of deemed dividend has been abolished and we have moved back to the classical method of dividend taxation.

As per the amendments made by finance act, 2020 now dividend will be taxed in the hands of the assessee at the applicable slab rates, TDS will be deducted by the Company on dividends exceeding ₹5,000/-, exemption u/s. 10(34) of the Act and tax u/s. 115O of the Act on the Company have been abolished.

Summary of the journey

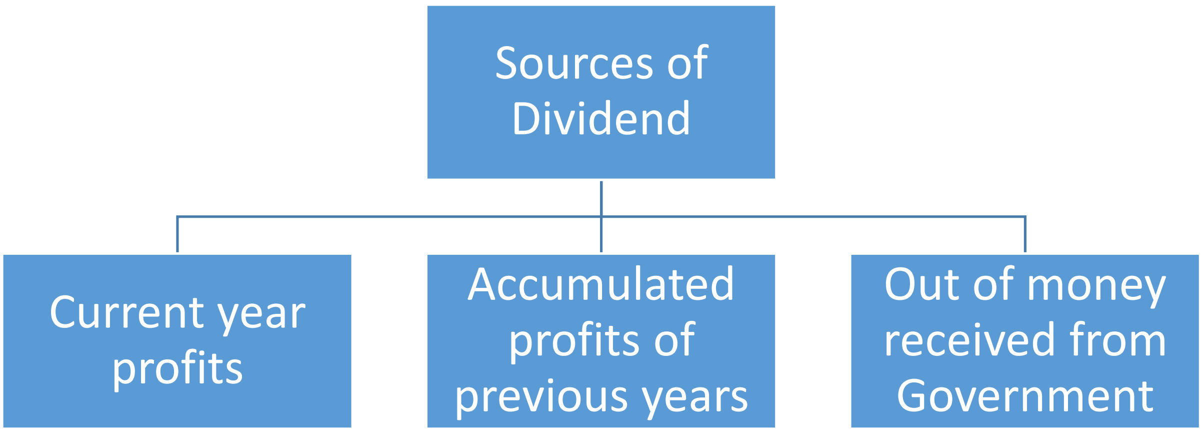


Chapter 4 Declaration & Payment of Dividend:

Now let us also see the provisions of Companies Act, applicable on dividends, in brief before getting into the taxation perspective.

As per the provisions of Chapter VIII of the Companies Act, any company other than section 8 company (i.e. Non-Profit Organisation) can declare dividend. There is no compulsion on the company to declare dividend and it is completely at the discretion of the board of directors. Dividend is to be declared by company at its AGM at a rate recommended by the Board or at a rate lower than that, but only after adoption of accounts of the Company.

As per section 123 of Companies Act, a company can declare dividend either from current year profits or undistributed accumulated profits or out of money received from central/state government for payment of dividend by company in pursuance of guarantee given by company or from combination of above sources. Further, the company cannot declare dividend unless it has set-off current or previous year losses and depreciation against the profits of the company.



In case of declaration of dividends in the years of inadequate profits, the Act further lays down the provisions for the maximum rate of dividend that can be declared, balance of reserves to be maintained post declaration of dividends, amount that can be withdrawn from accumulated profits, transfer of unpaid dividend to Unpaid Dividend Account, etc.

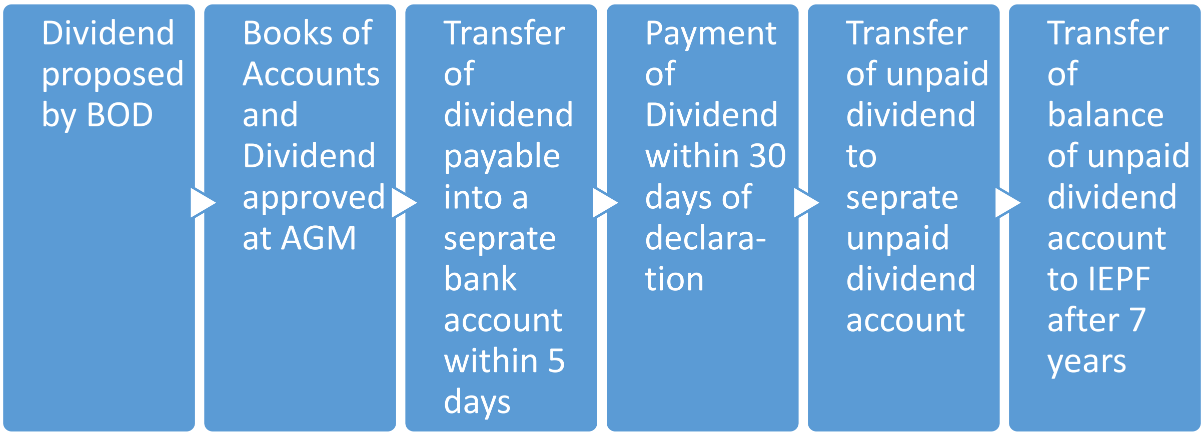
Once the dividend is declared by the company it becomes a debt for it payable to the shareholders within 30 Days of declaration. In case of default by the company in payment of dividend it will be liable to interest @ 18% p.a. also its directors can be held liable and punished. The act also specifies the mode of payment of dividend as cash [cash includes cheques, warrants and electronic mode] and if payment is done in any other mode it will be considered as a breach of provisions of the act.

As discussed earlier in the definition part, dividend defined as per Companies Act is inclusive in nature, so if a company distributes shares held by it as investment in lieu of cash payments for dividend, it will be dividend as per the definition of dividend. But as section 123(5) of the Act prohibits payment of dividend in any mode other than cash, this will be regarded as gift by the company and not dividend. The same can be verified from the judgement of *Hon'ble Bombay High Court in case of Indian Seamless Enterprises Ltd.* The judgement also stated that if it is paid so, it will be a breach of provisions of Companies Act, 2013 and will be liable for penalty under the Act.

Post declaration of dividends, the total liability towards dividend payable is transferred to a separate bank account, following which payment will be made within next 25 days, i.e. 30 days from date of declaration. Any sum that remains unpaid will be transferred to a separate unpaid dividend account within next 7 days. If dividend is not claimed from there also during next 7 years, then it will be transferred to Investors Education and Protection Fund (IEPF). Now, the shareholder will be supposed to collect his dividends from here.

Before the amendment made by Finance Act, 2020 company was also liable to pay DDT within days of declaration of dividend, however, now it will be required to deduct TDS at the time of payment of dividend.

Timeline of Declaration & Payment of Dividend



However, in case of dividend paid being interim dividend, approval of shareholders is not required. The directors can pay interim dividend at any time between two AGMs, however, no interim dividend can be declared by the directors, once the financial statements for that year have been approved.

The directors themselves can declare and pay the dividend at any time before approval of financial statements, but the source of dividend should be the same as mentioned earlier. Further, the mode of payment and period in which payment is to be made will also remain same.

Chapter 5 Waiver of Dividends by Shareholders

There may be situation when a company is willing to distribute profits by way of dividends, but the shareholder is of the view to waive it. Once the dividend is declared by the company it becomes a liability for it and is therefore payable by it which otherwise would lead to heavy penal consequences. On the other hand, shareholder may be willing to waive the dividend so as to be remunerated via large dividends in successive years or for the day to day utilization of company which will ultimately benefit the shareholders or for any other purpose.

Presently the Companies Act is silent on it and there is no legislation in India dealing with such scenario. However, certain listed companies like Sun Pharmaceutical Industries Limited and Sejal Glass Limited have exercised such options. Going through their forms and notes on the above scheme it is clear that waving of dividend is a gratuitous act and therefore nothing should be provided in return for such act.

Another condition necessary for such payments is that there should be provision in Articles of Association of the company allowing such wavier. This is the foremost condition because if the Articles do not permit such acts then the company will not be able to issue form regarding waiver of dividends and hence the shareholder will not be able to waive off the same. Thereafter, it is to be ensured that waiver of dividend is to be made before the shareholders approve the dividend proposed in AGM, i.e. dividend can be waived after it is proposed by directors but before it is approved by shareholders. This is to ensure that no liability for that dividend is recorded in the books of the company because once the liability is recorded it is to be paid within next 30 days as per the provisions of Companies Act.

Similarly, in case of interim dividends too, the form for waiver is to be submitted before the record date of the transactions. Further, it is to be noted that once the form for waiver has been submitted the same cannot be revoked and will thus be final.

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Chapter 6 ICAI & ICSI Guidelines:

Apart from provisions as per Companies Act and Income Tax Act, a company is also desired to ensure that there is no discrepancy in any compliances required by the Guidelines issued by ICAI & Secretarial Standards issued by ICSI, as the same may lead to qualifications in various reports issued by CA's and CS's.

For example, as per ICSI guidelines if a company has made default in payment of any earlier year dividend it is not allowed to declare dividend in current year unless the previous default is settled. However, no such restriction is levied on declaration of further dividend by the Companies Act.

Such restrictions are also levied in case company has defaulted in

- Repayment of Loan to Bank or FI, or
- Redemption of debentures, or
- Payment of interest to Bank or FI or debenture holders, or
- Repayment of Preference Shares, or
- Creation of Capital Redemption Reserve, or
- Creation of Debenture Redemption Reserve,

until the default has been made good.

Further, for the purpose of compliance of guidelines issued by ICAI and ICSI, we are required to ensure proper compliance of Accounting Standards or Indian Accounting Standards as the case may be. However, while ensuring the compliance of these standards, harmonious interpretation between these standards and the provisions of Act is to be made.

For example, as per the provisions of Ind AS, there are provisions for reporting and valuation of dividend in case of payment made through means of non-cash assets, but as per the provisions of Companies Act as discussed earlier, payment of dividend in mode other than cash is prohibited. Thus, although compliance is ensured as per the reporting standard issued by the ICAI, same is liable to penalty under Companies Act, 2013.

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Chapter 7 Why has DDT been removed by Finance Act, 2020?

Since the formation of BJP Government in the year 2014, one of the most promoted campaign of our Prime Minister Shri Narendra Modi has been of *'Make in India'.* Since his election, the PM himself and the entire government has been keen to set-up industries in India, increase the size of economy, decrease unemployment rate, promote export of goods and services, etc. but this all require one basic thing i.e. foreign investment in the country, which in-turn largely depends upon the ease of doing business in India.

As per the report of Bloomberg, ranking nations on the basis of ease of doing business, India jumped 14 positions to stand at 63rd position in year 2020, post reduction of corporate taxes and removal of DDT. Whereas in the year 2014, India ranked 142nd in the same list. Thereby, India has been continuously rising as a favorable and attractive destination for attracting Foreign Investment.

Thus, it can be easily understood that one of the primary reasons for removal of DDT has been to provide relief to Foreign Investors and make India more attractive investment destination.

To understand it better let us consider an example.

Prior to the amendment of tax laws, an Indian Company paying dividend was liable to pay DDT @ 15% plus surcharge of 12% and cess @ 4%. As a result, the total effective tax rate was 20.56%.

Now let us assume the corporate tax to be 25% (i.e. gross receipts below the threshold), surcharge to be 7% and cess will be 4%, so in all effective tax rate comes to 27.82%.

Particulars	**Indian Shareholder**	**Foreign Shareholder**
Net Profit of Company	₹1,00,00,000/-	₹1,00,00,000/-
Corporate income tax (@ 27.82%)	₹27,82,000/-	₹27,82,000/-
Distributable Surplus	₹72,18,000/-	₹72,18,000/-
DDT (@ 20.56%) (assuming on all)	₹14,84,020/-	₹14,84,020/-
Net dividend distributed	₹57,33,980/-	₹57,33,980/-
Tax free income in India	₹57,33,980/-	₹57,33,980/-
Additional tax on foreign shareholder in tax resident country (assuming @ 20%)	(assuming no additional tax of 10%)	₹11,46,796/-
Net income received by shareholder	₹57,33,980/-	₹45,87,184/-
Effective Tax on company's earning	42.66%	54.13%

However, as per new scenario, foreign shareholder will be able to take credit of tax paid in India on dividend, as it is no longer tax free in its hand and will thereby reduce the overall tax liability in its hands, or the foreign shareholder will be liable to lower tax rate as per tax treaty as the case may be, but ultimately his tax liability will reduce.

Now, let us see what will be the tax for a foreign investor say from Mauritius in comparison to an Indian Shareholder.

Particulars	**Indian Shareholder**	**Foreign Shareholder**
Net Profit of Company	₹1,00,00,000/-	₹1,00,00,000/-
Corporate income tax (@ 27.82%)	₹27,82,000/-	₹27,82,000/-
Distributable Surplus	₹72,18,000/-	₹72,18,000/-
Dividend Distributed	₹72,18,000/-	₹72,18,000/-
TDS on Dividend	₹7,21,800/-	₹3,60,900/-
Net Dividend received by shareholder	₹64,96,200/-	₹68,57,100/-

(*Assuming the tax rate on company to be same)

Here the rate of TDS for foreign shareholder has been taken as 5% (i.e. as per tax treaty), also 10% TDS is deducted for all shareholders assuming it to be all higher than ₹5,000/-. However, it may be possible that some Indian shareholders may get refund of TDS too. But ignoring that we can see that net dividend received by foreign shareholder is higher, thus, making India more attractive destination for investment.

Another major reason behind removal of DDT is technology. One of the reasons always argued to justify the provision of DDT was that it reduces a lot of paper work and cumbersome process by taxing the income at origination itself. However, this provision of taxation has always been considered iniquitous and regressive. But now, with the development of technology the process is no longer cumbersome. The same can also be verified from the memorandum explaining the budget, which reads as

'The present system of taxation of dividend in the hands of company / mutual funds was reintroduced by the Finance Act, 2003 (with effect from the assessment year 2004-05) since it was easier to collect tax at a single point and the new system was leading to increase in compliance burden. However, with the advent of technology and easy tracking system available, the justification for current system of taxation of dividend has outlived itself.'

Thus, making taxation of dividend simple and moving towards the Direct Tax Code has been a driving force in this amendment.

Chapter 8 Taxation of Dividend post amendment by Finance Act, 2020

Taxation in the hands of company declaring dividend

As per the latest amendments, a company declaring dividend will not be required to pay any DDT, as section 115O has been removed with effect from 01.04.2020. However, the company will be required to deduct TDS u/s. 194 of the Income Tax Act, @ 10% on dividend paid.

But taking into consideration the relaxations announced by the government, in lieu of supporting the economy post Covid-19 pandemic, the rate of TDS has been reduced to 7.5% for the current year, with effect from 14th May, 2020.

This TDS will not be required to be deducted in case of dividend being paid (in any mode other than cash) to an Individual receiving less than ₹5,000/- of dividend or in case of person receiving dividend submits Form 15G/H as applicable.

Similarly, no TDS is to be deducted in case of a recipient being

- An Insurance Company having full beneficial interest with respect to the shares owned.
- A Mutual Fund Company eligible for exemption u/s. 10(23D) of the Act.
- An Alternative Investment Fund (AIF) eligible for exemption u/s. 10(23FBA) of the Act.
- Corporations established that have been exempt from income tax
- Government or RBI

Apart from the above provisions, in case of recipient being a Non-resident, withholding tax will be held @ 20%.

Taxation in the hands of the shareholder

With the revocation of section 10(34) of the Act, post amendment by Finance Act, 2020, dividend received by a shareholder is no longer exempt and is taxable as per the applicable slab rates of the assessee.

In line with the above amendment, section 115BBDA has been revoked too i.e. has been restricted for dividends received till 30.03.2020. Further, section 57 of the act has been amended to provide that a shareholder can claim only interest expense as deduction against dividend income and in no case it is to exceed 20% of the dividend income received by the assessee.

Provision for removal of cascading effect on dividends received by Company

Section 80M that existed before Finance Act, 2003 has been reinstated in order to remove the cascading effect of tax on dividend received by a company from its subsidiary company and distributed to its shareholders.

As per the provision of section 80M, deduction will be allowed to a domestic company in respect of dividend received by it from a domestic company / foreign company / business trust, to the extent of dividend paid by it to the shareholders, at least a month prior to the date of return filing as per section 139 of the Act.

Thus, deduction has been allowed on the basis of actual dividend paid by the company, from the dividend received by it. However, in case of any deduction claimed once, cannot be claimed again in next year.

Let us understand this with the help of an example.

Dividend received in February 2021	₹100
Dividend distributed by company in September 2021	₹120
Dividend received in August 2021	₹100
Dividend distributed by company in September 2022	₹70

Computation of Income for F.Y. 2020-21				
Particulars				**Amount**
Total Income				₹100
Deduction u/s. 80M-	Dividend Paid	= ₹120		
-	Dividend Received	= ₹100		₹100
Net Taxable Income				**-**

Computation of Income for F.Y. 2021-22				
Particulars				**Amount**
Total Income				₹100
Deduction u/s. 80M-	Dividend Paid	= ₹90	(70 + 20)	
-	Dividend Received	= ₹100		₹90
Net Taxable Income				**₹10**

(*hypothetical example- Company having only dividend income)

Further, no deduction has been allowed on dividend received from Mutual Fund or vice versa or among Mutual Funds has not been allowed as deduction. Thus, it is applicable to double taxation.

Taxation of Dividends in the hands of Non-residents

Prior to amendment of provisions of DDT, foreign investors received dividend as exempt income as tax was already deducted on dividend declared by the company and therefore those investors were not able to take credit of any taxes paid in the countries of their tax residency. However, with the amendment of provisions of DDT now tax is to be paid by the recipient shareholder and therefore would provide the foreign investors with the benefit of availability of tax credit. Thereby reducing the tax cost on dividend income of foreign investors.

In case of dividends paid to non-resident persons, companies would have already withheld tax @ 20% (plus applicable surcharge and cess). However, non-residents are also subject to tax treaties entered by our country with our nations and as per the provisions of section 90 of the Act, a non-resident may choose between the rate as per treaty and act whichever is more beneficial to him. In case of treaty with various countries the rate of dividend as per treaty has been set at as low as 5% like in case of Hong Kong or Saudi Arabia. Thus, a non-resident person to whom this benefit is available may go for it and get his withheld tax reduce to such extent by providing the company with the required details for the same. But in case of Foreign Institutional Investors (FIIs) & Foreign Portfolio Investors the rate will 20% only. This, is so because these institutions may be a pass-through vehicle and beneficial owner may be different, residing in different country may be, so in light of it being a gray area, case specific decisions are better, after going through DTAA, charter documents of the institutions, etc.

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Chapter 9 Deemed Dividend:

As discussed in chapter 2 under the definition of dividend as per Income Tax, provisions of deeming dividend have been made an integral part of the definition. This, fictional provision of deeming has been the root cause of various controversial decisions.

The provisions of deemed dividend were introduced for the first time in the Income Tax Act, 1922. The then Finance Minister while describing the purpose of insertion of this clause stated that it is being done to bring within the tax net money paid by the closely held companies to their principal shareholder in the guise of loan and advances to avoid payment of tax. Therefore, if the said background is kept in mind, it is clear that provisions of sec. 22(2)(e) of the Income Tax Act, 1961 is only for the purpose of bringing in the tax net these payments made to avoid taxes.

The definition of deemed dividend discussed earlier has been amended last, in year 1987, when the provisions of deeming were introduced to the loans and advances advanced to any concern in which equity shareholder of company having at least 10% shareholding has substantial interest and is a member or partner of that concern.

This amendment was done for the purpose of removing the loophole used by various persons to reduce their tax liability.

Interpretation of Definition of Deemed Dividend:

As per the definition of deemed dividend given in income tax act, the definition of deemed dividend is inclusive in nature and its provisions are applicable only in the case of closely held companies, when they advance money in the form of loans and advances to any equity shareholder holding at least 10% shares carrying voting power, or to any concern in which such shareholder has substantial interest and is a member or partner of such concern or in case of payment made on behalf of such shareholder, but all this only to the extent of accumulated profits held by the company.

There are certain exemptions provided from this provision, like the above provisions of deemed dividend will not be applicable in case, advancing of loans form a substantial part of company's business.

Now coming to the analysis of this definition there have been a variety of interpretations made, judgements delivered and a variety of them are contradictory to each other. There is no exact interpretation of this definition i.e. what is to be considered as deemed dividend or not.

Let us go through some of the judgements and try to get a harmonious interpretation of this definition.

Payment in kind to be considered as dividend?

As per Companies Act, 2013 dividend cannot be paid in any mode other than cash, however, there is no such restriction in Income Tax Act. In case of *M.D. Jindal v. CIT [1986] Calcutta High Court* held that loan given in kind i.e. in the form of goods or other assets is duly covered within the ambit of section 2(22)(e) of the Act.

Advances to shareholders/sister concerns for the benefit of company?

While performing the day to day business activities, at various occasions companies end up paying advances to their sister concerns or to shareholders, which are purely commercial transaction by nature. However, on account of prima facie it being advance in nature, it is brought under the tax net by the Income Tax Act. Such transactions nowhere intent to prevent taxation or cause tax evasion but are then too taxed. A similar addition on account of money advanced to the shareholders and sister concern was made by the assessing officer in the case of *Bagmane Constructions Pvt. Ltd. v. CIT (ITA No. (473-476)/2013)*.

The company under consideration advanced money to the shareholders for the purpose of purchase of an agricultural land by its shareholders, which would then be transferred to the company on its conversion into non-agricultural land. This was done solely because the land being agricultural land could not be purchased by a Company.

This was completely a commercial transaction and the company had no intention to evade income tax. The assessee filed appeal against the order of the court and finally got a favorable decision from the Karnataka High Court.

The court held that loan or advance given to a shareholder or to any sister concern as a consideration for the goods or for the purchase of a capital asset, which indirectly would benefit the company advancing the loan, cannot be treated as deemed dividend under section 2(22)(e) of the Act.

A similar view was given by the Delhi High Court in the case of *CIT v. Raj Kumar [2009] (181 Taxmann 155)*, that the trade advances which are in the nature of money transacted to give effect to a commercial transaction would not fall within the ambit of the provisions of section 2(22)(e).

The decision of both the courts was based on the common consensus that section 2(22)(e) was introduced for the purpose of taxing the payments made to the shareholders by way of loans and advances which are primarily gratuitous and for avoiding taxes. Therefore, when the purpose of the provision was different, it should therefore be not applicable in case of pure commercial transactions.

Loans given to shareholders through current account?

The *Honorable Supreme Court of India in cases of Navnit Lal C. Jhaveri v. AAC [1965] (56 ITR 198), Punjab Distilling Industries Limited v. CIT [1965] (57 ITR 1) and Tarulata Shyam v. CIT [1997] (108 ITR 345)*, held that payments made to the shareholders through open current account would be deemed as advance and would be taxable in the hands of the assessee on account of it being deemed dividend.

The court further held that the period for which the sum was advanced won't matter and that it will be considered advance and will be liable to tax as per provisions of deemed dividend.

Further, there are judgements which approve it as dividend though the repayment is made within few days or the balance of current account in the books of the company is turned into credit by paying over and above the sum sue. Thus, even these kind of measures would not prevent it from being taxed as deemed dividend.

So to interpret it we can say that prima facie any loan or advance given to the persons mentioned in the definition as per Income Tax Act, provisions of deemed dividend will be attracted, no matter the number of days for which it was taken or the mode in which it was received. Even the inter corporate deposits are considered to be within its ambit. However, in case of it being a purely commercial transaction there are chances of getting favorable decisions, but additions are probable to be made. Expecting favorable decision may be optimistic and that too depends on your litigative luck as there are contradictory decisions too.

Similarly, it was held in case of *CIT v. K. Srinivasan [1963] (50 ITR 788) (Mad.)* that overdraft taken by the shareholder will be considered as deemed dividend u/s. 2(22)(e) of the Act.

Whether misappropriation of amount by major shareholder treated as dividend?

In the case of *G. Venkataraman v. CIT [1975] (101 ITR 673) (Mad.)* it was held that amount misappropriated by a shareholder shall not be regarded as deemed dividend in his hands, since in such case there is no lending or advancing by the company. As the section requires payment to be done as loan or advance, unless there is payment in such terms it is not to be regarded as dividend u/s. 2(22)(e) of the Act.

Payment done to relatives of shareholder to be treated as dividend?

Loan or advance given to relative of a shareholder will not be treated as a loan or advance given to shareholder and will not attract section 2(22)(e) of the Act, but it may be treated as payment done on behalf of the shareholder and will thus attract section 2(22)(e). The onus lies upon the assessee to prove that the transaction is not in nature of payment on behalf of assessee. *[Walchand & Co. Ltd. v. CIT (1975) (100 ITR 598) (Bom)]*

What is to be included in accumulated profits?

All the advances or loans given are to be considered dividend only to the extent of profits accumulated in the business. Now what is to be considered in accumulated profits and as on which date it is to be considered.

The same could be understood through the means of judgement of Supreme Court in the case of *P.K. Badiani (1976) [105 ITR 642]*. The apex court stated that for the purpose of calculation of accumulated profits all the profits of the company earned by usual and true sense are to be included. All the reserves created by the company out of profits are to be considered, however security premium reserve and capital reserve are not to be considered as the same are not created out of profits earned by company through usual means. The court further held that even development rebate reserves are to be considered for the said purpose. The court further held that for the purpose date as of which such reserves are to be calculated will be the date as on which advance or loan is given.

Beneficial shareholder and his substantial interest?

For the purpose of section 2(22)(e) of the Act, beneficial shareholder is to be considered and not the registered shareholder. In case the preference shareholders are given any right in voting, then they too are to be considered. Further, shareholding as on the date on which transfer took place is to be considered.

Substantial interest in case of company has been defined under section 2(32) of the Act, which states that a person will be considered to have substantial interest in a company when he has minimum 20% of the voting power of the company and is not entitled to a fixed rate of dividend from the company.

And in any other case, i.e. in case other than company, person holding right to minimum 20% of income of such concern will be considered to have substantial interest in the concern.

Taxation of Deemed Dividends:

Deemed dividend which was tax free in the hands of the recipient prior to amendment made by Finance Act, 2020 will now be taxable in the hands of the recipient. But this at times becomes cumbersome for the department to efficiently collect such taxes, because of the nature of transaction, person liable to pay tax, etc.

Before the amendment made by Finance Act, 2018 deemed dividend was taxable in the hands of the recipient as income from other sources under section 56 of the Income Tax Act.

This was so because the explanation to chapter XII-D specifically excluded deemed dividend from it and hence it was not taxable in the hands of the company declaring dividend, and therefore no exemption was available under section 10(34) of the Act to the recipient.

One of the major drawbacks of this kind of taxation was inefficient tax collections. It happened many a times that such advances were made by companies and no tax was paid on them. Then they were found out in assessment of the company advancing such loans. On the exploration of such fact, the Assessing Officer used to make additions in the income of company. Following this the company used to file an appeal and till the year when decision came, that too in favour of company because of the fact that company was not liable to pay tax on such dividends rather the recipient was liable to pay, reopening of assessment became time barred in case of the recipient company. Hence, no tax was actually received by the government in such cases.

Further, at times when addition was made to the income of the recipient company, the company used to file appeal and then the decision used to be again in favour of company as the beneficial shareholder was liable to such taxes and not the recipient company. The view held by courts in such cases was that, the company receiving such payments was not actual shareholder of the company, rather it was deemed dividend because of the common shareholder, and when it is not a shareholder then how can dividend be paid to it. Reference could be made to the decision of Supreme Court in case of *CIT v. Madhur Housing and Development Company (Civil Appeal No. 3961 of 2013). The court held that deemed dividend is not taxable in the hands of loan recipient concern if such concern is not a shareholder of the company advancing loan.*

Thereby the actual tax that was liable was not received by the company at most of the times. So in order to overcome these issues tax was made to be liable on company advancing such loans or advances. However, with the removal of dividend distribution tax by the government the issue will arise again, as the same is again taxable in the hands of the recipient or beneficial shareholder as the case may be.

Major judgements in cases of deemed dividends:

Below mentioned is a list of some important judgements delivered by various courts in cases relating to deemed dividends.

"Company advancing large amount to low-paid employee. Employee advancing loan to beneficial shareholder. Deemed dividend to be assessed in the hands of such shareholder."

-Alagusundaram Chettiar v. CIT (SC) [252 ITR 893]

"Shares held on behalf of minor children has to be included as the guardian can exercise voting power in respect of those shares in addition to shares held by guardian in his individual capacity."

-CIT v. T.P.S.H. Sokkalal (99) [236 ITR 981] (MAD)

"Materials advanced to the shareholder for construction that are to be set-off against cost of acquisition at the time of purchase of property from such shareholder to be considered as dividend."

-D. Jindal v. CIT (Cal) [164 ITR 28]

“Loan given by subsidiary company to its holding company covered within ambit of section 2(22)(e).”

-Sadhna Textile Mills Pvt. Ltd. v. CIT (1991) [188 ITR 318] (Bombay HC)

“Partnership Firm is to be treated as shareholder even if it is not a registered shareholder of the company and its partners are registered shareholders, for the purpose of section 2(22)(e).”

- CIT v. National Travel Services (2012) [347 ITR 305] (Delhi HC)

Chapter 10 Why are HNI’s losers as per new taxation policy?

Before the amendment of dividend taxation by Finance Act, 2020, it was usually High

Net Worth Individuals, who were liable to additional tax @ 10% u/s. 115BBDA. They were made to pay tax, plus surcharge and cess on this 10%. However, with this amendment they will be no longer required to pay any additional tax. So why are they at loss?

The answer for this is, in earlier scenario, if a shareholder had any other income too, apart from dividend income, that too in excess of say ₹10 lakhs, he was taxed on that income at the relevant rate, however his dividend income on which DDT was already deducted up to the extent of ₹10 lakhs was left tax free in his hands. This in all caused him to pay tax around 20% on this dividend income, however, the same was liable to tax @ 30% plus surcharge plus cess. But now, post amendment he will be liable to pay tax on it @ 30%.

Thus, the overall liability to tax will increase in case of such tax payers. Further, the effective rate goes as high as nearly 43% in case of individuals, thus, leading to huge tax liability in the hands of HNI’s.

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Chapter 11 Accounting of Dividend

Proposed Dividend

Before the introduction of Indian Accounting Standards, accounts of companies were prepared in accordance with Accounting Standards. As per the provisions of AS- 4 'Contingencies & Events occurring after the Balance Sheet Date' a company was required to show the proposed dividend as Short Term Provisions in the books of the company post the approval of Shareholders i.e. it was shown as a liability in the books of the company considering the dividend declared as an adjusting event.

However, with the introduction of Indian Accounting Standards with effect from 01.04.2016 amendments were made by the Ministry of Corporate Affairs by notification dated 06.04.2016 in the schedule III of Companies Act, 2013 so as to provide for implementation of Ind AS. In the same notification, along with several other changes, amendment was also made in the disclosure requirements of proposed dividend so as to bring it in line with Ind AS. Thus, with effect from 01.04.2016 proposed dividend was required to be disclosed in the notes of the companies and not in the financial statements as a liability.

Therefore, in order to harmonize the provisions of AS-4 with Companies Act, 2013 ICAI amended AS-4 and required proposed dividend to be shown in notes and not financial statements, unless and until a statute requires so. Similar disclosure of proposed dividends is done as per Ind AS – 32 in notes following the financial statements of the company, by those who prepare accounts as per Indian Accounting Standard.

Payment of Dividend

Payment of dividend (whether interim or otherwise) is treated as an appropriation of profit. Thus, it is debited to profit and loss appropriation account at the time of preparation of final accounts of the company.

Further, in case of interim dividend as there is no such thing like proposed dividend, it is directly paid by the company on recommendation of the directors through bank account or any other mode and thereafter the said amount is debited to the profit and loss appropriation account.

Chapter 12 Distribution of Profits by Mutual Funds:

As we have discussed above regarding provisions of tax on dividend declared by a company to its shareholders, similarly, there are provisions for tax on distribution of profits by mutual funds to their unit holders. The same are discussed in brief below:

Similar to provisions of section 115O, a Mutual Fund and certain specified companies like Unit Trust of India were liable to pay additional tax under section 115R of the Income Tax Act, on the amount of profit distributed by them. These profits received by the unit holders were tax free under section 10(35) of the Act. However, with the amendment of section 115O by Finance Act 2020, section 115R has been amended too.

The above provision of section 115R was applicable only in cases of Mutual Funds specified u/s. 10(23D), these included equity oriented mutual funds. Hence only they were given such benefit u/s. 10(35) of the Act. As only such funds were liable to additional tax u/s. 115R.

As per the latest amendments, section 115R and 10(35) will not be applicable for profits distributed by Mutual Funds after 31st March, 2020. Following this amendment profits received will be taxable in the hands of the recipient. Further, for the purpose of ensuring effective tax collection, provisions of TDS on such income has been revived. And in line with above amendments section 10(23D) has been amended accordingly.

Thus, Mutual Fund or any other specified company paying profits will now be liable to deduct TDS u/s. 194K @ 10% in case of resident recipients, were the amount of payment does not exceed ₹5,000/- or were the profit is on account of capital gains. However, in case of non-resident recipient, rate is 20% as per section 196A.

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Chapter 13 Various measures used to avoid tax on Dividends:

Buyback of Shares in lieu of Dividends:

Until the insertion of section 115QA by Finance Act, 2013 in the Income Tax Act, buyback of shares by the company in lieu of dividend was used as one of the most common measure of tax saving.

The reason behind this buyback was that, were a company has distributable surplus, it has to options –

- Declare Dividends, or
- Buyback its shares

As the declaration of dividend attracted DDT and buyback of shares was taxable as Capital Gains in the hands of the shareholder, the income tax payable was lower in case of Capital Gains. Further, the benefit of indexation was also available on long term capital gains. So in order to avoid tax on dividends, buyback of shares was seen as a way-out of these taxes.

In the event of company / shareholders desired to maintain the share capital of the company, bonus shares were issued to the company, once the period of limitation on issue of shares post buyback was over as per Companies Act. Bonus shares too didn't attracted any tax liability, the share capital of the company was restored back to original amount.

Finally, as an anti-tax avoidance measure the government introduced section 115QA in the Finance Act, 2013. As per the provisions of this section, the company is made liable to additional tax @ 20% plus surcharge @ 12% plus applicable cess. This tax was levied on the amount paid by the company on buyback of shares less the amount received by company on the shares at the time of issue. While the sum received by the shareholder was left tax free. The effect of this could be understood from the example given below,

Particulars	**Amount**
Issue price of shares	₹10
Purchase price of shareholder	₹100
Buyback price of company	₹200
Taxable amount	₹190 (i.e. ₹200-₹10)

As the benefit of indexation has been removed and also the actual cost of acquisition is not considered, the tax liability in buyback of shares raises substantially, thereby making it undesirable as a means of tax planning. Thus, this amendment has resulted in removal of a major loophole in the taxation provisions. Further, the government made it applicable even on listed companies vide Finance (No. 2) Act, 2019.

Routing of Transactions through Tax Haven countries:

For years, countries like Mauritius & Singapore have been the largest source of foreign investment to India. However, it is known to all, that these investments are only routed through these countries for the purpose of them being Tax Haven countries. The total investment in India from Mauritius tops the table with more than 135 billion USD, followed by Singapore with more than 83 billion USD.

The companies desirous of making investment in India, used to set-up shell companies or holding companies in these countries, with no economic activity. Tax rate applicable to companies in Mauritius in only 15%, which can be lowered to as low as 3%, further there is no capital gain tax in Mauritius, also the country levies no withholding tax on dividends and interest payments.

The Government in recent times has started cracking down these Tax Havens. In May 2016, Government successfully negotiated amendment in its Tax Treaty with Mauritius to tax Capital Gains on transfer of Indian shares from April 2017 onwards. A similar agreement was entered with Singapore to tax the Capital Gains on transfer of shares in Indian Companies.

This discouraged companies from setting up companies in Singapore or Mauritius for the purpose of tax saving.

However, with abolition of DDT this will not be the scenario. Now, as dividends are taxable in the hands of the recipients, the rate of tax on dividends in case of foreign investors will be lower of 20% (i.e. as per Act) or rate as per treaty. This, will again promote companies for investing in India through these nations.

For example, the lowest tax rate on dividend as per tax treaty with Mauritius is 5%. Thus, the withholding tax rate applicable will be 5% and not 20%. This is even lower than the TDS of 10% on dividends paid to Indian shareholders. So now if an investor from USA invests in India through Mauritius, dividends paid to it will be liable to only 5% tax which if it invested directly through USA would have been 15%. Also, as there is no withholding tax on dividends paid by a Mauritius company, the actual investor i.e. an American will receive it effectively at a tax of 5% only.

This is one of the major reasons why government expects its Tax Revenue to fall due to removal of DDT. As earlier tax was collected on dividends paid to foreign investors through DDT, the rate of which was higher than the rate that will now be applicable as per tax treaties.

Thus, it will now be one of the most intriguing areas of tax saving on dividends, through routing of investment from various such countries having such favorable tax treaties with India, along with attractive taxation for investment in those countries.

Chapter 14 Conclusion:

Though dividend seems to be a small topic, but it has far reaching implications, both on taxation and investment perspectives. It has been one of the driving forces while formation of various provisions by the government and a key contributor to the consolidated fund of India, with its huge tax collection capabilities.

In a nutshell I would say, reversal of dividend taxation to classical system is a nice move to align the taxation policy of India with most of the other countries of the world. It will surely lead to ease in doing business in India and further attract foreign investors by removal of tax credit leakage.

Now let's see whether DDT has become history or the history will repeat itself and DDT will return.

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