Abolishment of Dividend Distribution Tax

The existing regime, of payment of Dividend Distribution Tax (DDT) by the Indian Company, and thereafter such dividend being exempt in the hands of shareholders, has been replaced with direct taxation of the dividend income. While this is likely to benefit non-resident shareholders (other than foreign portfolio investors not structured as a company/NRI's in higher tax bracket), it is likely to create an additional tax impact on Promoters of Indian company/ resident high networth individuals, increasing compliance burden for smaller shareholders, simultaneously.

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Abolishment of DDT and its impact on Investors – Resident and Non-resident

Amidst high expectations, the Union Budget 2020 was presented by the Finance Minister, on 1st February 2020. Several changes were made to tackle the growth slowdown, which is a prevailing phenomenon, both at domestic and international level. This article focuses on one of the proposed key amendments to the Income-tax Act, 1961 ('the Act') introduced by Budget, which relates to the abolishment of DDT, which was currently levied at an approximate rate of 20.56%, on the company, which distributed dividend.

Existing Provisions Relating to Dividend Taxation

The applicability of tax provisions on any dividend, is at two level; one at the level of the company that declares /distributes or pays dividend, and another, on the recipient of such dividend which could either be a resident , or a non-resident.

- **Tax implications in the hands of the Company**

a) Under the existing laws, even though dividend constituted income in the hands of the shareholders, the tax on such dividend was payable by the company which declared dividend, @ 15% of the gross dividend under section 115-O (plus surcharge and cess) (except dividend covered under section 2(22)(e), where the rate of DDT was 30%), which amounted to an effective DDT of 20.36%. However, no deduction or

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credit is allowable to the company, in respect of such DDT.

b) However, where a company, whose whole of nominal value of equity share capital is held by a business trust, declared dividend to such business trust, subject to certain conditions, such dividend is not liable to DDT, in view of specific exemption under section 115-O(7). Similarly, dividend declared by a unit of an International Financial Service Centre, is also not liable to DDT, subject to certain conditions.

c) In a similar manner, specified companies and Mutual Funds are currently liable to pay additional income tax on income distributed by them to their unit holders, at specified rate, which were thereafter, exempt from tax in the hands of the unit holders under section 10(35).

In all such cases, where dividend was exempt in the hands of the shareholders, there was no requirement to deduct TDS on dividend referred to in Section 115O, under the provision of Section 194.

- **Tax implications in the hands of the Shareholder/ recipients**

The dividend received by a shareholder, which was covered under section 115O, was exempt in their hands under section 10(34). However, where a specified shareholder (other than an Indian Company/Trust covered under section 12A or 12AA, amongst others), received dividend exceeding ₹ 10 lakhs, such recipient was liable to pay tax @ 10% (plus applicable surcharge and cess), in addition to the DDT paid by the company. There was no expenditure which was allowed as a deduction in computing dividend income.

Even in the case of non-resident shareholders, dividend received from the Indian company was not liable to tax in India. Accordingly, the Indian Company declaring dividend was not liable to deduct TDS from such dividend. However, in cases, where such dividend was liable to tax in the hands of the non-resident in their country of residence, there was generally no credit available for the dividend distribution tax paid by the Indian Company. In view of this, such companies had a very low return on investment, which effectively discouraged them from investing into India. Further, the profits of such companies were not repatriated by them due to high incidence of dividend distribution tax in India, and corresponding taxability in certain cases in their country of residence.

Proposed Provision under Finance Bill 2020

In order to remove the adverse impact of the existing regime, the Finance Bill proposes to revamp the provision relating to taxation of dividend, both in the hands of the company declaring such dividend, as well as the recipient of dividend. Correspondingly, the provisions of Section 115-O, Tax on distributed profits of domestic companies, Section 115R - Tax on distributed income to unit holders, Section 115BBDA - Tax on certain dividends received from domestic companies, Section 10(34) - Dividend income from domestic company, Section 10(35) - Income from specified mutual fund of the Income Tax Act, 1961(IT Act), shall be operative till 31st March 2020.

The changes which have been made, can be summarised as under :

- *Tax implications in the hands of the Company/ Mutual Fund etc.*

  The company which declares dividend will no longer be liable to pay dividend distribution tax, on or after 1.4.2020. However, the company declaring dividend shall be liable to deduct TDS @ 10% if aggregate payment of dividend during the FY is more than 5000 INR, under the provisions of Section 194. Further, it is proposed to insert a new Section 194K, where any person, who is responsible for paying to a resident, any income of Mutual Fund units referred to in Section 10(23D), or units from the administrator of the specified undertaking or units from the specified company shall be liable to deduct income-tax @ 10%, where the income exceeds ₹ 5,000.

  On similar lines, it is proposed to amend Section 194LBA, to provide for deduction of tax by business trust, on dividend income paid to unit holder, @ 10% for both resident and non- resident unit holders.

The benefit of these tax rates are available, provided the recipient is beneficial owner of such dividend, and not receiving such dividend on behalf of another person, and the non-resident does not have a Permanent Establishment (PE) in India.

- **Tax implications in the hands of the shareholder/ recipients**

  Section 10(23FC) of the IT Act is proposed to be amended to provide that all dividends received/ receivable by business trust, from a Special Purpose Vehicle, shall be exempt income in the hands of such business trust. However, dividend income received by the unit holders from business trust, would be taxable in the hand of unit holder of the business trust, under the provisions of Section 115UA of the IT Act, and would no longer be entitled to exemption under section 10(23FD) of the IT Act .

  The provision of Section 57 of the IT Act, have been amended to provide that deduction of interest expense, which shall not exceed 20% of dividend income, shall be allowed against the dividend income. Besides this, no further deduction shall be allowed from dividend income, or income in respect of units of mutual fund or specified company.

- **Section 80M – Removing the cascading impact of taxes**

  In order to remove the cascading effect of taxation of dividend, the budget proposes to insert Section 80M, which provides that if the gross total income of a domestic company (Company A), includes any dividend income from any other domestic company (Company B), Company A shall be allowed a deduction against the dividend income, to the extent of the amount of dividend distributed by Company A. However, the deduction will be allowed to the company only in respect of the dividend distributed by Company A one month prior to the due date of filing of return. The benefit of Section 80M is available even in respect of companies which opt for the lower tax regime introduced vide Section 115BAA and Section 115BAB of the IT Act.

- **Taxation of Dividend received by non-residents**

  The Finance Bill, 2020, proposes that dividends paid to non-resident shareholders will be liable to tax at 20% under section 115A of the Income-tax Act, 1961. However, since a non-resident can opt to be governed by the provision of the Tax Treaty, if these are more beneficial, the non-resident shareholder can also opt for the provision of Treaty to pay tax at a lower rate on dividend as under, wherever the rates under the IT Act are higher:

S.No.	Country	Rate
1	UK	10%
2	USA	15%
3	Singapore	10%
4	Netherlands	10%
5	Luxembourg	10%
6	China	10%

The benefit of these tax rates are available, provided the recipient is beneficial owner of such dividend, and not receiving such dividend on behalf of another person, and the non-resident does not have a Permanent Establishment (PE) in India.

Whenever a decision has to be made on whether the provision of the Treaty – (Article 10 – Dividend) are more beneficial, the following aspects should be kept in mind :

- Certain tax treaties provide that the benefit of the reduced rate of 10-15% shall be available only when the non-resident owns, more than 10/25% shareholding of the company declaring the dividend.
- Consequent to the amendments made, under the Multilateral Instrument, to which India is a signatory, and which forms part of the Base Erosion and Profit Shifting initiative of the OECD, where a non-resident receives such dividend on behalf of other person who is the beneficial owner of such dividend, they may not be eligible for the lower taxation benefit. For example, if a Singapore shareholder receives payment on behalf of a USA shareholder, the provision of India Singapore Treaty would not be applicable.

Thus, the impact of the proposed changes on foreign companies whose dividend income is taxable in their country of residence (say at 20%), the situation would be as under :

Particulars	Position under Existing laws	Position under Finance Bill
Tax on Indian company	20% - DDT	Nil
Tax on Foreign Investor (Corporate) in India	Nil	10-15%
Tax Credit Available to Non-resident in Home Country	Nil	Available to the extent of Tax payable in Home Country
Tax in Home Country	20%	5% (assuming 15% credit of TDS is available)
Total Tax Cost	**40%**	**15-20%**

However, one of the most significant impact of the current changes in the hands of the non-resident is, that the TDS deducted by the Indian Company at the time of payment of dividend, will now be available as a credit to the non-resident, where it is liable to pay any taxes on such dividend in its country of residence. The extent of availability of credit, shall depend on the respective treaties, and on the domestic tax laws of the country concerned.

Non-resident has a PE in India

It should be noted that the provision of Article 10 - Dividend, in several Treaties, specifically provide that they shall not be applicable in case where the Non Resident has a Permanent Establishment (PE) in India. In such a case, the dividend income would be taxable as business income, on net basis. Once the dividend income is taxable as business income, the question that would arise would be whether any deduction will be available against such income? Generally, the deduction of expenses against business income, even in Treaty cases, is allowed as per the local laws of India. As discussed above, since the proposed amendment seeks to restrict the allowability of expenses against such dividend income to 20% , the foreign company may be liable to pay tax on remaining dividend at the rate of tax applicable to the foreign recipient. In such a case, the foreign taxpayer may evaluate if the provision of the IT Act are more beneficial and continue to be governed by such provision on a case to case basis.

Impact of the removal of DDT in the cases of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trust (InvITs)

Under the existing provisions of the Income Tax Act, dividends received by REITs and InvITs are exempt from tax in their hands under the provisions of Section 10(23FC) of the Act. Further, where REITs/ InvITs, further distributes such dividend to its unitholders, it is exempt from tax in their hands under section 10(23FD) of the Act.

The provision of the finance bill proposes to amend the tax provision to provide that dividend received from REIT/ InvITs, shall henceforth be taxable in the hands of the unit holders at applicable rates and the REIT/ InvITs will be liable to deduct tax under section 194LBA of the Act on such dividend at the rate of 10%.

Conclusion

Advantages

- The taxpayers would be liable to pay taxes on dividends, at the rate of tax applicable to them. Since, the existing rate of DDT was 20.56%, taxpayers who are under a lower tax bracket, would end up gaining from the proposed provisions.
- The return on equity capital for foreign investors may increase, particularly in those cases, where the taxes withheld in India is available as a tax credit in the country of residence of such investors. Such Investors need to pay tax at 5 to 20%, depending on their country of residence. Even Foreign Portfolio Investors, who are organised as companies, can avail similar benefits of reduced taxation.
- Foreign companies can consider repatriating profits in their Indian subsidiaries at lower rates. This would help particularly in cases where the Indian entities operate on a cost plus model and do not undertake other independent operations.
- Indian companies that both receive dividend, and pay dividend can claim a deduction of dividend paid under section 80M, thereby reducing the burden of tax on them, provided certain conditions are satisfied.

Disadvantages

- TDS withheld by company from dividend payments shall impose additional burden on small taxpayers, who may end up filing return and claiming a refund, in cases where their total income is not liable to tax/liable to tax at lower rates.
- Promoters/ Taxpayers in higher income tax bracket, would be liable to pay taxes, which may be at a rate of 34 to 43%, depending on the slab of income in which they fall, as against the existing DDT plus tax payable in cases where dividend during the year exceeded ₹10 lakhs. Similarly, Foreign Portfolio Investors, who are not organised as companies, would be liable to pay tax at higher rates, compared to the existing DDT regime. ■