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Changes to the DDT structure

INTRODUCTION

On February 1, 2020, finance minister Ms. Nirmala Sitharaman, unveiling the union budget proposed a dynamic change to the existing dividend distribution tax structure of the country. The proposed set of changes are aimed towards reducing the burden of taxation which currently falls upon corporates while declaring and distributing dividends to its shareholders, thereby making the country a more attractive venue for investments.

Broadly, dividend is a monetary distribution made by a company out of its profits calculated after deduction of taxes. However, the companies that were paying out dividends to its shareholders under the previous regime, were required to pay a tax at source in the form of dividend distribution tax ("**DDT**") at an effective rate of 20.56% (including cess and surcharge). This in a way led to a double taxation at a corporate level.

India being the only country in the world to tax a company on the distribution of dividend, has by its Budget, 2020 now proposed to abolish the DDT payable by the companies making it now taxable only in the hands of the recipients – at their applicable income tax rates/slabs.

From a foreign investments perspective, many market experts and economists have advocated for this change since a long time as any dividend which was earned by a foreign holding company from its wholly owned domestic subsidiary led to a tax leakage leading to an indirect loss of profits to the foreign holding company. The foreign company would thereafter be required to pay tax on the dividend so received in its home country in accordance with the taxation laws applicable in its jurisdiction of incorporation. Since DDT was paid by the Indian company, the foreign company receiving the dividend at time faced a lot of difficulties while attempting to claim the foreign tax credit in its parent jurisdiction. This in turn resulted in the increased tax liability for the investors, thereby reducing the overall rate of return on equity capital.

Though certain tax treaties have been executed in several jurisdictions which limit the tax on dividend received by the shareholders to a lower rate or otherwise make the recipient entitled to a refund from tax authorities in its parent jurisdiction, the overall relief did not usually equate with the loss on account of double taxation suffered by a company.

ANALYSIS

Pre-budget 2020

Pursuant to section 115-O of the Income Tax Act, 1961 ("**Act**") any domestic company distributing or declaring dividend was required to pay DDT at a rate of 15% (plus applicable surcharge and cess, effective rate being 20.56%). The dividend received from the domestic company was not taxable in hands of the shareholders. The tax was required to be paid to the government within 14 days of the dividend declaration, distribution or payment whichever was earlier. Failure of the same attracted a penalty under Section 115P of the Act being simple interest at the rate of 1% for every month or part thereof on the amount of such tax has remained due for the period beginning on the date immediately after the

last date on which such tax was payable and ending with the date on which the tax is actually paid.

DDT on Mutual Funds

Mutual funds that invest less than 65% of the corpus in equity are termed as non-equity funds like debt funds for tax purposes. On debt-oriented mutual funds, DDT at the rate of 25% (excluding surcharge & cess) was required to be paid.

Dividend or income distributed on equity mutual funds was taxed at 10% as per the budget 2018-19.

Post-budget 2020

The finance minister has abolishing DDT on companies expressly stated that all income through dividends, shares and mutual funds, will from April 1, 2020 be treated on par with the regular income and the taxes will be applied on such category of incomes on par with the tax slab rates applicable in the said individuals case. This would mean that the tax burden in the hands of the individuals falling under the 30% tax bracket will increase while individuals falling under the 20% tax bracket will remain almost neutral. The individuals who are liable to pay tax less than the rate of DDT, if the dividend is included in their income will be the ones reaping the most benefit of this change.

The benefit from the abolishment of the DDT also extends to the foreign companies that were facing a challenge in claiming credit in their home country for DDT paid by their Indian subsidiary and/or investee company. Now, a foreign company's dividend income will be taxed at a rate of 20% (plus surcharge and cess) under Section 115A of the Act, however, they will get to claim credit in their home country. The company may also opt for the tax treaty benefit rates upon the fulfillment of conditions provided under the respective treaty.

Further, a larger quantum of profit will be available to the companies for distribution as dividend to its shareholders or to be utilized in business operations thereby increasing the overall productivity of the company. Therefore, this move would not only increase the dividend which the company may pay but also encourage various investors to invest furthermore on account of a more structured regime for taxation with respect to dividends.

CONCLUSION

Although a revenue loss of INR 2,50,000 million has been estimated on account of the abolishment of DDT, the additional tax paid by the shareholders is expected to compensate for this loss. More importantly from an investor, particularly foreign investor perspective, this move may increase the attractiveness of the Indian capital markets to provide relief to a large class of investors.

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