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A PROGRESSIVE SYSTEM OF TAXATION

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Public Finance, Taxation & Black Money incl. Government Budgeting

As a concept, ‘dividend’ has been in existence since the inception of the Income Tax Act. Any shareholder in a company is entitled to dividend as a return on investment. Dividend covers various elements of payouts from a company and seeks to tax those at some stage. The question is: at what point should the dividend be taxed and how? The matter assumes significance since corporates pay tax on their profits and any tax on the distribution of post-tax profits amounts to double taxation. The Finance Bill, 2020 has reverted to the classical system of taxing dividends (in the hands of the shareholders). The Bill seeks to withdraw the dividend distribution tax (DDT) payable by the company. This move has created ripples since high-net-worth individuals never expected a full tax in their hands, which is being sought to be achieved by the proposal.

The three methods of taxing dividend are the classical system; the simplistic system or DDT regime; and the imputation system. The classical system was in vogue till 1997-98. According to this system, the dividend was taxable in the hands of the shareholder, subject to the then available deduction under Section 80L for a maximum of 12,000. This was a progressive system.

The Finance Act of 1997 analysed the merits and demerits of the classical system and embarked on the route of the simplistic system of taxing dividend in the hands of the distributing company. In the process, millions of shareholders were spared the burden of offering dividends as tax in their hands. The DDT system replaced the classical system from 1997-98. The rate of DDT started at about 10% and climbed to 20.56%. The advantage of DDT was that tracking of dividend in the hands of the company became easier and collecting the tax on dividend was a painless process. The main drawback was that the treaty agreements with countries like the U.S. did not permit the set-off of the DDT paid against the tax liability of the shareholder. DDT was simple but inequitable since it made no distinction between a low taxpayer and a high taxpayer.

With India registering substantial growth between 1997 and 2020, corporate performances also registered progress and dividend pay-outs increased. The income tax payer came under the radar of the IT department. This development made tracking of the shareholder much easier. The withdrawal of DDT came as a relief to the corporate sector which has wanted DDT to be removed and the effective corporate tax rate in India to be reduced. Corporates are also required to conserve cash for further growth. This largely prompted the government to revert to the classical system for taxing dividend.

However, this means that the starting rate of tax works out to 10% and the highest rate works out to, say, 43%. Tax paid in dividend is out of money earned and received and more often than not represents holding of shares passed on by generations without any cost incurred. On this score, discharging tax at the maximum marginal rate more than justifies the principle of equity and sharing with the government in the overall developmental agenda. Shareholders in other countries with a protective treaty regime can receive dividend attracting tax rates as low as 5%. The distortion in the current regime viz. the foreign shareholder being taxed at a much lower rate than the Indian counterpart is obvious. This would require some correction. The main contention of the high-net-worth individual is that while the classical system is acceptable as a concept, the maximum tax rate is an unexpected extra burden.

Some countries follow the imputation system. The dividend is taxed in the hands of the shareholders but they are also allowed a set-off of a portion of the corporate tax discharged by the company. In many ways, the imputation credit resembles an underlying tax credit granted to non-residents under certain treaties entered into by India. While there are complexities in that system, it mitigates the hardships caused by the double taxation impact of dividend distribution.

Indian promoter groups control a majority of shareholding in Indian companies. For them, the wealth is largely represented by the value of shares and the dividends received over a period of time. These have been passed on to successive generations. These shares can be held by individuals, HUFs, family companies, or family trusts. Any decision to declare dividend is analysed from the standpoint of the company and the standpoint of the entity receiving the dividends. As long as dividends were received tax-free, the structure was irrelevant. But with the current proposal even family trusts can be taxed at the maximum rate. This blow is bound to force companies to revisit their strategy of paying dividends.

The move to the classical system is not only well-conceived but also tilted towards the appropriate progressive system of taxation.

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