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TAXATION OF DIVIDENDS: ANALYSIS OF UNION BUDGET IN DIRECT TAXES (2020- 21) UNDER THE FINANCE ACT, 2020

Authored By-Somya Kumari

Abstract

According to **the Black's Law Dictionary**, dividend refers “to distribution of profits/rewards earned by a company/ corporation to its shareholders”.¹ When a company makes a profit or has a surplus, it can distribute a portion of that earnings to shareholders as a dividend. However, if money that isn't allocated or distributed is re-invested in the company (called **retained earnings**).² As for a company, a dividend plays very important source of revenue for shareholders. In India, taxation of dividend income has undergone several changes over the years. For the first time in 1997, Indian introduced **the Dividend Distribution Tax (‘DDT’)** which exempted dividend income in the hands of shareholder but obliged the corporation to pay a fixed rate of DDT.³ However, this move was considered regressive and inequitable, so in 2002, the burden of dividend tax was shifted to the shareholders but that again shifted back in the hands of company in 2003. Now, the Finance Act, 2020⁴ abolished DDT and brought back the classical system of dividend tax income in the hands of shareholders.⁵ The paper is divided into three parts.

Part I deals with the main analysis of new amended divided taxes regime under the Finance Act, 2020⁶ including the impact on the investor for mutual funds as well as MAT on dividend income of foreign company. Part II takes an illustration of impact of dividend taxes on non-resident shareholders through the new amended Finance Act, 2020⁷. Part III concludes the remark.

¹ BLACK'S LAW DICTIONARY, 11th edn., 2019.

² TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

³ TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

⁴ The Finance Act, 2020

⁵ Ruchi Jain, Return of the “classical system” of dividend taxation in Union Budget 2020, [2020] 114 taxmann.com 125 (Article).

⁶ The Finance Act, 2020

⁷ The Finance Act, 2020.

Part-I

Before delving into the main paper, I will discuss new dividend regulations and analyzed the new changes introduced by the Ministry of Finance in Union Budget 2020-21 through one case law i.e., *Deputy CIT vs Total Oil India 2021*⁸.

Analysis Of New Amendment In Dividend Taxation

Regime Under Finance Act 2020

Now, firstly, I will highlight the budget amendment done for direct taxes that is particularly DDT regime which has been abolished and India has re-established *the classical system of dividend tax* in the hands of shareholders, which was prevalent in past.

In 2020, the Hon'ble Finance Minister Nirmala Sitharaman in her budget speech adopted this classical system of dividend tax which will be effective from financial year ('FY') 2020-21 and will apply to dividends distributed on and after 1 April 2020.⁹ Further, it is clear that the removal of DDT will result in a loss of INR 25,000 crore in annual revenue, in order to do so, the DDT loss would be compensated by the shareholders through their higher personal and corporate tax collections on account of dividend tax. In the former DDT regime, the company used to pay dividend tax @**20.56%** and as for shareholders, the dividend income was exempted.¹⁰

The classical system of dividend tax is a huge advantage for making tax collection easier and therefore, it considerably improved cost of doing business in India was especially for foreign investors. As, there were some issues regarding foreign investors for **double taxation** because DDT was tax on company not on shareholders and there were difficulties with getting DDT tax in their home jurisdiction.¹¹ For this, in 2019, re-establishment of classical system of dividend tax with reduced corporate tax brought India an attractive place for foreign investors.¹² Since the DDT regime abolished, companies will be able to properly distribute dividends across the group without incurring DDT costs. This would be especially beneficial to publicly traded corporations, since they will be able to collect dividends from

⁸ [2021] 127 taxmann.com 774 (Mumbai - Trib.)

⁹ Vishal Agarwal, Summary of Dividend Taxation, TAX Guru (2021).

¹⁰ [2020] 114 taxmann.com 432 (Article)

¹¹ [2021] 123 taxmann.com 354 (Article)

¹² [2021] 123 taxmann.com 354 (Article)

joint ventures, subsidiaries, and associates and distribute them to ultimate shareholders without paying DDT costs. Even in unlisted industries, dividends from joint ventures, subsidiaries, and associates may be received with a one-time tax expense and held at the receiving business level. This amendment brought a significant move for foreign investors who do not presently benefit from the DDT tax credit in their home jurisdictions will gain from this modification. Also, such foreign investors can now claim credit from withheld taxes only through the availability of the benefit of the tax treaty.

This would also impact on the investor as for taxes reasons, mutual funds that invest less than 65 percent of their corpus in equity are referred to as non-equity funds, such as debt funds. Investors who seek recurring income from the dividends of equity-oriented funds have to reevaluate their approach. They would receive a lower in-hand return as a result of the taxes on returns. The investor's hands, nevertheless, are still free of taxation on the payout. The DDT will be taken out by the fund house before any dividend distributions. As other schemes are tax-free, dividend plans won't be advantageous for LTCG below Rs. 1 lakh. Despite the additional tax, investors hoping for a steady income can still invest. Dividend schemes would regularly consume your earned gains if your purpose is to create wealth. Additionally, the benefit of compounding is lost when the dividend is paid, defeating the very goal of wealth development. Due to their excellent returns, equity-oriented funds continue to rule despite the new tax laws. Simply wait a little before making any hasty decisions.

MAT on divided income of a foreign company: Only when a foreign firm is a resident of a nation with whom India has a DTAA and conducts business via a PE located in India are MAT provisions applicable on such company. However, it shouldn't be subject to the presumed taxation provisions of Sections 44B, 44BB, 44BBA, or 44BBB. Certain adjustments are made to the foreign company's earnings once it has been decided that it must pay MAT.

However, if they are credited (or debited) in the profit and loss account and the corresponding income is taxable at a rate lower than the rate of MAT, the following incomes (and costs claimed in respect of them) are added back to (or removed from) the net profit: (a) Capital gain from securities; (b) Interest; (c) Royalty; (d) FTS.

As a result, a foreign corporation is exempt from paying MAT on the aforementioned earnings. The Finance Bill, 2021 has amended Section 115JB to provide that dividend income and expenses claimed in respect thereof shall be added back or reduced from the net profit if such income is taxed at a lower rate than MAT due to DTAA, taking into account the taxability of dividend in the hands of the foreign company

Critical:

Though, new amendment should provide the corporate sector more freedom in treasury management and capital mobility within the company because most of the time shareholders makes contribution to company, so it should be at the cost of a larger tax burden on shareholders. In the event of a dividend received by an Indian firm or business from a foreign corporation, cascading relief is not accessible. This appears to be a "miss" in the new proposal, given an Indian business can deduct dividends from a foreign subsidiary company under the present DDT system. Dividends received from overseas corporations are likewise subject to the same rules.

Impact Of New Dividend Tax Regime Under The Finance Act, 2020¹³

1. Resident Shareholders:

- A. **Individuals and HUFs:** For Resident Shareholders being individuals and HUFs, dividend income earned by them shall be taxable as per the applicable tax slab rates. In addition to this, the maximum surcharge applied on dividend tax is limited to 15%. Therefore, it will be taxed at a maximum effective rate of 35.88 percent for individuals and HUFs with a total income of more than INR 1 crore.¹⁴
- B. **Partnership firms and limited Liability Partnerships ('LLP'):** the dividend income shall be taxable at an effective rate of 31.2% and in case of total income exceeds INR 1 crore, then it would be taxable at 34.94% inclusive of surcharge.¹⁵
- C. **Domestic Companies:** the dividend income is taxed as per effective tax rates, which is range from 25.17% to 34.94%. if a company chooses concessional tax regime, then shall be subjected to Minimum Alternate Tax ('MAT') at 17.47%.¹⁶

2. Non- Resident Shareholders

¹³ Supra 2.

¹⁴ [2020] 114 taxmann.com 432 (Article).

¹⁵ [2020] 114 taxmann.com 432 (Article).

¹⁶ [2020] 114 taxmann.com 432 (Article).

- A. Foreign Portfolio Investors ('FPIs'):** the dividend tax for non-resident shareholders has undergone several changes over the years and finally, in Union Budget 2020-21, the dividend income earned by Foreign Shareholders (only applicable to those income earned from Indian portfolio companies) shall be taxable at the rate of 20% inclusive of both surcharge and cess, and as for Indian portfolio companies will subject to liability to withhold taxes at such rates.¹⁷ In case for tax treaties, the beneficial tax rate on dividend income would be ranging from 5% to 15% subject to certain conditions in Section 80G of the Income tax Act 1961¹⁸ (Donations). However, it is important to keep in mind that such a beneficial tax rate isn't accessible when withholding tax is applied on dividend income paid to FPIs. The dividend income under tax treaty formed between Indian and FPIs would be able to claim that beneficial tax rate when submitting their tax return and demand a refund of excess tax withheld if certain requirements are met.¹⁹ Therefore, despite FPIs being eligible for a beneficial tax rate under the applicable tax treaty, it is necessary for the FPIs would have to assess the impact on their cash flows because Indian portfolio companies would continue to limit their withhold taxes @20% inclusive of surcharge and cess (*this has been recognized the tax rate prescribed in the domestic tax laws*).²⁰ For this, FPIs might potentially contact the Indian government to request appropriate changes to the country's domestic tax legislation in order to²¹:
- permit tax withholding at the tax treaty's specified rate.²²
 - FPIs will be able to get a reduced withholding tax order from the Indian Revenue Department. The Indian portfolio firms would be permitted to withhold taxes at the lower rate provided in the tax treaty under such a lower withholding tax order.²³

¹⁷ [2020] 114 taxmann.com 432 (Article).

¹⁸ The Income Tax 1961

¹⁹ Supra 2.

²⁰ TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

²¹ TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

²² TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

²³ TAXATION OF DIVIDENDS: A Change in Finance Act, 2020 Dhruva Publication, 5th edn., (May 13, 2020).

PART II

Now, I will discuss the case where after introduction of Finance Act 2020²⁴, dispute rose regarding protection given to shareholders in foreign jurisdiction related to dividend income- tax treaty specific provision (DDT was exempted for shareholder until 31st March 2020) in the hands of non-resident shareholders.

Deputy Commissioner Of Income Tax Mumbai Vs. Total Oil India (P.) Ltd.²⁵ 2021

Fact:

Dividend income was exempt from taxes in the hands of non-resident shareholders until March 31, 2020, when the company was required to pay additional corporation tax in the form of DDT at an effective and flat rate of 21% (regardless of the shareholder's tax rate). Now, as of April 1, 2020, the Ministry of Finance has removed the DDT regime, and dividend income of shareholders would be taxable, as stated in the Union Budget 2020-21. Though, prior to the year, the policy goal of introducing DDT was to guarantee that administrative simplicity was achieved by using a single point of tax collection. The issue of applicability or relevance of beneficial tax rates under tax treaties was always in dispute or doubt since the Indian companies pays the DDT and not the non-resident shareholders (dividend tax was exempted). This issue of applicability was brought for consideration before the Delhi Bench of Tribunal in the year 2019, however, the court ruled in favour of taxpayer and held that the DDT rate should be capped (restricted) by the rate established for dividend income under the tax treaty. The Delhi bench of the Tribunal's decision was later followed by the Tribunal's Kolkata bench in a decision. In this case, the disputed year was 2015-16 in which the taxpayer had distributed dividends to its shareholders, some of them whom were French residents. During the ongoing appellate processes before the Tribunal, the Taxpayer submitted an additional cross-objection, arguing that the DDT rate should not exceed the rate set in the India-France tax treaty.

The Mumbai Bench of Tribunal also referred the issue in which Special bench took for consideration. The issue framed was:

²⁴ The Finance Act, 2020

²⁵ [2021] 127 taxmann.com 774 (Mumbai - Trib.)

“Whether the protection guaranteed by the tax treaties under s.90 of the IT Act 1961²⁶(Removal of doubts), in respect of dividend income tax in their home or source jurisdiction, can be extended, even in the absence of a specific treaty provision to that effect, to the DDT under s.115-O (DDT-Profit of domestic companies) in the hands of a domestic company?”²⁷

Analysis Of Tribunal Order And Comment:

The Tribunal's Mumbai bench approved the Taxpayer's cross-objection and then voiced doubts (s.90 of the IT Act) about the accuracy of the conclusions reached by the Tribunal's co-ordinate benches. I will just discuss the important following key reasons ruled by the tribunal on why it doubted the correctness of those earlier decisions:

So, coming to the first issue was whether, because the Assessee-resident of India ('Company') paid taxes in India in respect of its own liability, such taxation in India could not be covered or impacted by a tax treaty provision unless the linked tax treaty contained a special provision allowing treaty protection to be extended. It was **held** that DDT is solely taxable on the company and not shareholders, henceforth, treaty protection for resident company is not available in the absence of a specific provision. The Tribunal also ruled that the DDT should be viewed as dividend paying company's tax liability that is completely discharged by such company. In this regard, the Tribunal relied on the SC ruling in *Godrej & Boyce Manufacturing Company Limited v. DCIT*²⁸ where the Court has said that DDT cannot be equated to a dividend tax paid on behalf of the beneficiary shareholder. It also added that in a circumstance where an India-resident company is viewed to be paying tax in India in respect of its own liability, such taxation in India cannot be protected or impacted by a tax treaty provision (including non-residents) unless the tax treaty contains a specific provision.

If such tax treaty provisions clearly allow for treaty applicability to dividend taxes, the Tribunal reasoned that whenever the contracting states to a tax treaty wanted to extend the treaty's protection to DDT, it has been specifically stated in the treaty itself. For this, the Tribunal referenced the **India-Hungary DTAA (Tax Treaty)**²⁹, which protocol said that tax on distributed profits of an Indian resident corporation paying dividends should be deemed to be taxed in the hands of shareholders, and

²⁶ The Income Tax Act, 1961, s.90.

²⁷ [2021] 127 taxmann.com 774 (Mumbai - Trib.)

²⁸ (2017) 394 ITR 449 (SC)

²⁹ Supra 23.

that such tax shall not exceed 10% of the gross amount of dividend.³⁰ That is a main clause in the protocol, which is basically gives an integral component of the treaty, and the protocol to a treaty is just as obligatory as the main treaty's terms. Also, the tribunal ruled that even if the tax treaty provision is not accessible in other tax treaties, the DDT rate should not be limited by the applicable tax treaty provision. Regardless of how beneficial such provisions in other tax treaties are, they cannot be deduced from a pretty aggressively creative process of tax treaty interpretation. Tax treaties are engagements between treaty partner countries, and they must be read as they are, not as they would have been if they had been drafted otherwise.³¹

Furthermore, the Tribunal ruled that there shall be no tax credit for shareholders because such tax treaties do not allow shareholders to claim tax credits for DDT paid by the corporation in which their shares are owned or held.³² The DDT, the Tribunal reasoned, cannot be compared or equated with a tax paid by or on behalf of a shareholder in this situation. When it comes to DDT, this taxability is completely tax-neutral for foreign resident shareholders, and the treaty protection can only benefit the domestic corporation. The sought-after treaty protection goes much beyond the aim of tax treaties.³³

The tribunal also applied foreign jurisprudence on taxes like DDT while citing the ruling of the South African High Court in **Volkswagen of SA (Pty) Ltd v Commissioner of SA Revenue Service**³⁴. In this case, it involved a tax similar to the DDT known as secondary tax on companies (STC) which was used to pay on the distribution of dividends. The HC ruled that “STC is a tax on a company declaring dividends and not on dividends”. Further, the tribunal observed that while the opinions of a foreign judicial body are not binding on any Indian legal body but they deserve to be considered in a fair and open-minded way.

³⁰ Supra 23.

³¹ Supra 2.

³² [2020] 114 taxmann.com 125 (Article)

³³ Id.

³⁴ Case no. 24201/2007

PART III

Conclusion

From the above paper analysis, I would like to conclude that dividend income should be taxable to both the company and shareholders in an equitable manner. The new changes in Finance Act, 2020 brought several doubts and difficulties especially for foreign jurisdiction – tax treaty provision, so for that, India should adopt an ideal agreement to resolve these difficulties. There are several cases which has been adopted in a such way where the shareholders must pay the DDT only when treaty obliged, if not, then shareholders must compensate to such losses incurred by company for their double taxation. Furthermore, looking at the new amendment, it should have given corporate more freedom in treasury management and capital mobility rather than shareholders, so that it would reduce the tax burden on company. The top business may strive to honor this opinion by maintaining a strong dividend payment track record. Dividends boost a company's image and help keep investors on board. Dividends are also favored by shareholders since, in many countries, they provide tax-free income for them.

