Dividend Tax Policy — An Evaluation

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Abstract

Corporate dividend tax is well known since its introduction by the Finance Act, 1997. The present article is an attempt to focus on the impacts of dividend tax on dividend-paying companies, shareholders, government and capital market, with relevant suggestions for improvement.

Key-Words : Dividend, Dividend Tax, Domestic Company, Cost of Capital.

Introduction

The Companies Act 1956 has not defined the term 'Dividend'. The Income Tax Act 1961 in Section 2 (22) has given an inclusive definition of the term laying down five cases which are also to be considered as cases involving payment of dividend (called 'Deemed Dividend').

Thus, besides dividend declared in a general meeting (i.e., Interim dividend) or in an Annual General Meeting (i.e, Final dividend) the Income Tax Act 1961 includes the following as situations involving payment of dividend (to the extent of accumulated profit) :

a) Any release of asset by a company to its shareholders.

b) Any issue of bonus shares to preference shareholders or debentures, debenture stocks or deposit certificates to shareholders.

c) Distribution by a Company, on liquidation, to its shareholders.

d) Distribution of money to shareholders on capital reduction.

e) Loan/advance given by a closely held company, not in the ordinary course of business of money lending, directly or indirectly to a shareholder having substantial interest (10% voting power) in the business of the company.

In fact, the Income Tax Act 1961 considers an event as payment of dividend if it involves release of profit in favour of shareholders.

Dividend Tax

Section 115-O of the Income Tax Act requires a domestic company to pay tax at specified rate on dividend distributed, declared or paid by it to its shareholders. Section 115-O is not applicable in case of dividend covered by Section 2(22)(e) (mentioned in (e) above). In other words, a domestic company shall pay tax [subsequently called 'Dividend tax') on all dividends (interim +final+deemed {except on those in the nature of loan/advance mentioned in Section 2(22)(e)}] declared, distributed or paid by it. Section 115-O was introduced by the Finance Act, 1997.

Taxability of Dividend in Pre- and Post-dividend Tax Period

The next two paragraphs deal with implication of dividend from domestic company before introduction of Section 115-O and after introduction of Section 115-O.

Before introduction of Section 115-O

1. A domestic company was not required to pay tax on dividend declared, distributed or paid by it.

2. Dividend was included in the Gross Total Income of the shareholders.

3. The shareholders were entitled to get deduction on account of dividend from domestic company, subject to a maximum limit, u/s 80L (for non-corporate assessees) or U/s 80M (for corporate assessees).

After introduction of Section 115-O

1. A domestic company is required to pay tax on dividend declared, distributed or paid by it except for those mentioned in Section 2(22)(e).

2. Such dividend is not taxable in the hands of shareholders Section 10 (34).

3. Section 80M is withdrawn and section 80L is amended to exclude divided income from the list of eligible income under that section.

Features of Dividend Tax

1. It is a tax not on income but on appropriation of income.

2. The same amount is considered twice for the purpose of charging tax under the same tax law — firstly as part of taxable income and secondly as dividend declared.

3. Provision for dividend tax is a 'below the line' item. So long as the amount is called income of the company provision for tax in relation to that is considered 'above the line'. But when that amount (after tax) is named 'dividend' provision for tax in relation to that is shown 'below the line'.

Thus, appropriation made by the investee company on account of dividend consists of two parts —

i) amount payable to shareholders,

ii) amount payable to Government as dividend tax.

Impacts of Dividend Tax

The company needs to earn an additional amount on account of dividend tax. So, to satisfy the expectation of its shareholders and to meet the dividend tax, a company needs to earn $D(1+t_d)$, whereas earlier it was sufficient to earn D on equity share Capita. (D : dividend ; t_d : dividend tax per rupee. Thus, cost of equity will increase. As a result many of the projects which were, before introduction of Section 115-O, viable may now (after introduction of Section 115-O) turnout non-viable.

A new negative financing cash-flow item, dividend tax, will drain out cash flow that could otherwise be utilised for financing expansion programmes.

To avoid the pressure on cash flow if dividend is reduced for a firm with a pattern of stable dividends, this break will have an effect on investors' confidence more severe than the failure to pay dividend by a firm with unstable dividend policy. In fact, a tendency for maintaining higher retention is seen in a number of cases. But because of uncertainty, shareholders may give a higher value to the near dividends than the future dividends and capital gains. Moreover, all categories of capital gains arising from transfer of share are not exempt from income tax. Due to these, a gap is created between the actual and expected dividend, and it is not surprising to see that market price of the share is affected thereby specially in a situation when a study (Oza, 2004) says that 'the bird in the hand theory is more important in India'.

This impact on share price can be shown by putting dividend tax in Walter's share pricing model as shown below :

$$P = \frac{D}{K} + \frac{r}{K} \cdot \frac{E - D(1 + t_d)}{K}$$

Decline in price will be by (–) $\frac{r}{K}\ {}^{Dt_d}/_{K}$

P : Price per share

E : Earnings per share

D : Dividend per share

r : Internal rate or return

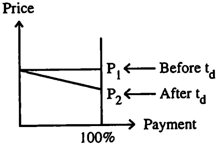
K : Cost of Capital

t_d : Dividend tax per rupee

Extent of Decline

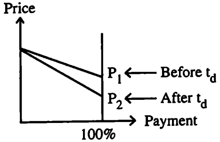
a) for a normal firm (r = K)

will be by $\frac{Dt_d}{K}$



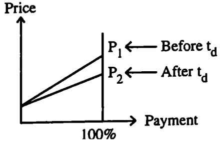
b) for a growth firm (r>K)

will be by $\frac{r}{K}\ {}^{Dt_d}/_{K}$



c) for a declining firm (r<K)

will be by $\frac{r}{K}\ {}^{Dt_d}/_{K}$



As is evident from the above presentation, there will be decline in price per share on payment of dividend and consequent payment of dividend tax for all categories of firms (normal, growth and declining). But, the magnitude of decline is highest in case of a growth firm followed by a normal firm and declining firm. Moreover, a normal firm is not allowed to remain indifferent to dividend policy due to introduction of dividend tax. Thus, a normal firm can save this fall by zeroising dividend (i.e. D=0).

Again, when Walter suggests 100% payment, it will not entirely go to the shareholders. Thus, the question arises whether dividend income is really exempt from tax. The answer is in the negative. Because to the extent the companies are reducing the payment of dividend to manage the fund required to pay dividend tax, it is really the shareholders who are indirectly paying the tax. In that respect, even those shareholders who were, prior to introduction of dividend tax, enjoying the benefit of deduction U/s 80L/80M, are now paying tax on dividend.

What is dividend tax for?

Going through the above impacts of dividend tax we see that (1) in the real sense dividend is not exempt from tax. (2) only long term capital gains from transfer of share are granted exemption very recently and (3) dividend tax has a negative effect on share price. So the motive behind introduction of dividend tax is not to encourage capital market. The motives behind its introduction are actually to ensure a higher revenue for the government (by withdrawing exemptions U/s 80L and U/s 80M) and boosting retention for generating internal capital.

Comment

Generation of internal capital is, no doubt, good, but only when that capital can be used for growth and this is possible only when the firm is in the growth sector (r>K). So, dividend tax can properly serve its purpose only in case of growth firms. But in case of normal firms and declining firms dividend tax is causing growth of underutilised capital. Moreover, in the absence of dividend tax market price of shares of such firms can be improved by higher dividend payment. This improvement in market price will indirectly increase revenue earning of the government through improved capital market condition.

Conclusion

The Government should draw a proper balance between its short-run need for revenue and growth of the economy. A prudent dividend tax policy can play a great role in this respect.

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