Editorial

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# No dividend in taxing shareholder

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THE 2002-03 Budget brought about a fundamental change in the mode of taxing the dividend received by shareholders. Instead of collecting tax on 'distributed profits' (hitherto levied at a flat rate of 10 per cent), it reverted to the old practice (before 1997-98) of taxing dividend in the hands of shareholders. For deducting tax at source (TDS), a limit of Rs 1,000 was prescribed.

After the change of guard in the Ministry of Finance, the Government has set up a Task Force under Mr Vijay Kelkar to examine the issue of taxing dividends 'de novo' and make suitable recommendations. In the meanwhile, with a view to accommodate the concerns of the small investors, it has raised the exemption limit for TDS to Rs 2500.

Clearly, the Government is having second thoughts about its decision announced in the Union Budget. Which way will things move? While much will depend on the recommendations of the Task Force, we need to know what prompted it to go for a change in the first place.

The system of taxing personal income in India is 'progressive'. This essentially means that a person earning more should pay tax at a higher rate and vice versa. Currently, even as income up to Rs 50,000 per annum is exempt from tax, income in the ranges of Rs 50,000-60,000; Rs 60,000-1,50,000; and Rs 1,50,000 and above is taxed at 10 per cent, 20.4 per cent and 30.6 per cent respectively.

Now, if dividend income is taxed in the hands of shareholders, each person will pay tax at a rate depending on the income slab in which he falls. Thus, if his total income (including income from dividend) is over Rs 1,50,000 per annum, he will pay tax at 30.6 per cent. At the other extreme, a person whose total income is less than Rs 50,000 per annum will not pay any tax.

If, on the other hand, the Government levies tax on the profits distributed as dividend by the company at 10 per cent, this will be tantamount to taxing all individuals at a 'uniform' rate, irrespective of their income. In other words, the system treats all categories of investors — rich or poor — at par. Instead of being progressive, the system may be branded as regressive.

The apparent differential treatment in taxing profits distributed as dividend comes into sharper focus in the context of 'promoter' shareholders.

By virtue of their sizeable equity holding in the company, they get a major share of the dividend. Now, if these high net-worth individuals are taxed at 10 per cent on their dividend income, as against 30.6 per cent, this may raise hackles!

It has even been alleged that the 'promoter' shareholders have exploited this by declaring exceptionally high dividends. The critics have argued that the higher the dividend amount, the greater will be the 'fortuitous' gain represented by the difference between 30.6 per cent and 10 per cent being the tax actually paid. This could be prevented if income is taxed in the hands of shareholders, the argument goes.

On the face of it, one may get carried away by the impression that the current dispensation was pro-rich and anti-poor. We should not, however, jump the gun. There is an urgent need to analyse the underlying facts. Only then can meaningful inferences be drawn.

First, on the question of alleged enrichment of promoter shareholders, the results of a survey — reported in a leading financial daily some time ago — reveal that the quantum of dividend distributed by major companies did not show any increase after changeover to the mode of levying tax on distributed profits in 1997-98.

Notwithstanding the above, even if the amount distributed by way of dividend increases, its benefit will accrue not just to the promoters but to all other shareholders as well. Undoubtedly, as an individual entity, the gain to the former will be substantially higher than the latter. But this is pretty 'logical' in view of the promoter being the single largest shareholder in the company.

What about the apprehension of differential treatment in regard to taxation of dividend income? In switching over from taxing it in the hands of the 'recipient' to the point of 'distribution', clearly, a person with income in excess of Rs 1,50,000 per annum stands to gain to the extent of 20.6 per cent. Likewise, a person whose income is in the range of Rs 60,000 to Rs 1,50,000 per annum will also gain, though his gain is lower at 10.4 per cent ( 20.4 - 10.0 ).

A person whose income is in the range of Rs 50,000 to 60,000 per annum, will remain unaffected as in both the dispensations, he is taxed at the same rate i.e., 10 per cent.

Only, a person having an income of less than Rs 50,000 per annum will be adversely affected. But then, this is merely 'academic' as by definition, he is most unlikely to have any surplus — after meeting his bare minimum household needs — for investing in shares.

In view of above, various categories of investors will be better off (in any case, no one will be worse off ) under the regime of levying tax at distribution point. Simply because a particular group gains more than another group does not imply discrimination. The charge would be valid only if the gain of the former is at the expense of the latter. This is clearly not the case here.

While deciding on a viable system of taxing dividend income, the Government should keep in mind three major objectives:

( i ) incentive for investment in shares

( ii ) maximisation of tax revenue, and

( iii ) ease of administration.

A system of levying tax in the hands of shareholders will be far from achieving any of these. Thus, if an investor is required to shell out 20-30 per cent of his income from dividend as tax (inevitable under this system), this will discourage him from investing in shares. Investment in equity being 'risk' capital, he has a major stake in getting attractive returns. A high rate of tax on dividend income will seriously undermine this.

Generally, public offer for sale of equity (IPO) are made at a premium to the par value. This results in a substantial lowering of effective return on the amount actually invested. For instance, if a share with a par value of Rs 10 is bought for Rs100, the dividend at, say, 25 per cent will work out to 2.5 per cent. On top of this, if the Government takes away 30.6 per cent as tax, the investor will be left with a meagre 1.7 per cent!

Eventually, a high tax rate will affect revenue. The collections will also be affected on account of the 'non-disclosure' of dividend income. Even in cases, where tax is deducted at source (dividend amount in excess of Rs 2,500), temptation for non-disclosure will remain. This is because, by not declaring it, the investor will gain 20.6 per cent (assuming TDS at 10 per cent).

The administration of this system will involve unprecedented extra work for both the companies and the Income-Tax authorities by way of handling hundreds of thousands of TDS certificates. Millions of investors will have to undergo the nightmare of claiming 'refunds' from the Department.

On the other hand, under a dispensation of levying tax at a 'uniform' 10 per cent on distributed profits, the disincentive to invest in shares is substantially reduced. As a result, the Government can hope to collect more revenue. And, since the collections are not dependent on disclosure by the assesses, there will not be any leakages and all the dues will flow in to the Treasury.

Above all, various stakeholders — investors, companies and the Department — will be saved from the nightmare of TDS certificates, refunds, and so on.

Finally, there is need to ponder over an age-old and fundamental question. Should the income from dividend be taxed at all? Having already levied tax on the profits of the company, if the Government levies tax on dividend — whether at the point of distribution or in the hands of shareholders — this is tantamount to 'double' taxation!

Ideally, the Government should refrain from taxing the income from dividend. This will boost the share market and help deploy surplus funds with the public to accelerate the pace of development.

If this is not possible, the system that has prevailed in the last five years — tax on distributed profits at a uniform 10 per cent — should be continued with.

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