

# Income Tax Provisions on Taxability of Dividend Income

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**Background:** Taxability of dividends has been a matter which is very close to the heart of small shareholders. Unfortunately, changes are made to the taxability in the hands of shareholders or otherwise over a period of time. Until 31<sup>st</sup> March, 2020 (AY 2021), a dividend from an Indian company, was not liable to tax u/s 10(34) of the Income Tax Act, 1961. Consequently, the domestic company was required to pay Dividend Distribution Tax (DDT) under section 115-O. (Thus, when DDT was paid by the company, Dividend was exempt in the hands of shareholders (Subject to Taxation of Dividend @ 10% when dividend exceeded Rs 10 Lakhs).

## **Taxability of Dividend Income in the hands of Individual/HUF w.e.f 1.4.2020 AY 21-22 onwards:**

Dividend income earned by resident shareholders being individuals and HUFs will now be included in the taxable income and as such will be liable to tax at the slab rates applicable to them.

For a shareholder being an individual or HUF whose total income exceeds INR 1 crores, dividend income will be taxable at a maximum effective rate of 35.88% as per the old regime. (inclusive of surcharge and cess).

The maximum surcharge on tax on dividends would be restricted to 15%.

## **Deduction of expenses from dividend income:**

Where the dividend is assessable to tax as business income, the assessee can claim the deductions of all those expenditures that have been incurred to earn that dividend income, such as collection charges, interest on the loan, etc. Whereas if the dividend is taxable under the head of income from other sources, the assessee can claim a deduction of only interest expenditure which has been incurred to earn that dividend income to the extent of 20% of total dividend income. No deduction shall be allowed for any other expenses, including commission or remuneration, paid to a banker or any other person for the purpose of realizing such dividend.

## **Tax deducted at source on dividend income:**

Domestic companies must deduct tax under section 194 before paying dividend. This results in 10% (no surcharge and cess) TDS from dividends distributed/declared/paid to resident shareholders. No TDS is deductible if the dividend paid during the financial year does not exceed Rs. 5,000.

In the case of resident shareholders who have not furnished their **Permanent Account Number**, the company will deduct tax at 20% (no surcharge and cess). Needless to mention that TDS will be allowed to be offset against the tax liability of the shareholder.

In the case of non-resident shareholders, the tax will be deducted at the rate of **20%+ surcharge and cess as applicable (Maximum surcharge restricted to 15%)** (Subject to provisions of respective DTAA).

**Summary of TDS rate applicable on payments of Dividend on Non-Resident Individuals/HUF (as per old regime)**

Category of Dividend Recipient	Dividend less than ₹ 50 lakhs	Dividend more than ₹ 50 lakhs but less than ₹ 1 crore	Dividend more than ₹ 1 crore but less than ₹ 10 crores	Dividend more than ₹ 10 crores
Non-Resident Indian	20.80%	22.88%	23.92%**	23.92%**

\*\* TDS rate is the same since the maximum surcharge on tax on dividends would be restricted to 15%.

**Cases where no TDS on dividend is liable to be deducted by the payer:**

- The dividend is paid to LIC, GIC, or its subsidiaries or to any other insurer with respect to the shares that are owned by them or in which they have a full beneficial interest.
- Dividends paid to a business trust, as defined in clause (13A) of section 2, by a special purpose vehicle referred to in the Explanation to clause (23FC) of section 10, are exempt from TDS.
- If you have submitted Form 15G/15H (lower/no deduction of withholding tax) in case your income is below the taxable limit.
- Any other person notified by the Central Government in the Official Gazette who is also exempt from TDS deduction

**Advance Tax Liability on Dividend:**

While computing advance tax from 1.4.2020, the taxpayer will need to consider dividend income in the total taxable income.

Section 234C which is interest on late/short payment of quarterly advance tax shall not apply to any shortfalls in the instalments of advance tax where such shortfall is on account of underestimate or failure of estimation dividend.

Advance tax payment is not applicable to senior citizens (age 60 & above) in case they do not earn income from business & profession.

**Other sums received by the shareholders from a company which are deemed dividend income in the hands of shareholders:**

'Dividend', generally, means the sum paid to or received by a shareholder in proportion to his shareholding in a company out of the total profit distributed. The word 'deemed' has not been defined anywhere in the Act.

The sub-clauses (a) to (e) of section 2 (22) of the Income-tax Act bring into the ambit of dividend certain distributions/outflows that would otherwise not have been considered as dividend in the ordinary sense.

Additionally, the Finance Act, 2024 introduced section 2(22)(f) with effect from 1st October, 2024 where amounts received on buy back of shares by the companies are chargeable as 'deemed dividend' income.

**Sec. 2 (22) (a): Distribution entailing the release of assets of the company:**

...any distribution by a company of accumulated profits, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets of the company...

Issuing bonus equity shares to equity shareholders does not result in release of assets to the shareholders and hence it is not taxable as dividend. While issuing bonus shares, the accumulated profits simply get converted into share capital of the company. Issue of bonus shares in no way alters the asset position of the company.

If a company offers shareholders an option to accept bonus shares or cash and the shareholders accept cash, then such act leads to outflow of assets from the company to shareholders. In such cases, it would be taxable as dividend in the hands of the shareholder.

**Sec. 2 (22) (b): Distribution entailing the release of assets of the company:**

...any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not...

**Section 2(22) (c): Distribution on liquidation:**

...any distribution made to the shareholders of a company on its liquidation to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not...

Distribution by a liquidator by itself does not trigger taxability as dividend income unless the company had accumulated profits before it went into liquidation.

Shareholders are subject to capital gains tax u/s. 46 (1) on assets distributed on liquidations. Capital Gain is calculated after deducting from the consideration price or market value, the deemed dividend u/s. 2(22)(c).

**Section 2(22) (d): Distribution on reduction of capital:**

...any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits whether such accumulated profits have been capitalised or not...

Distribution to shareholders on account of reduction of share capital attracts tax implications u/s. 2(22)(d) of the Act and also capital gains taxation u/s. 45 of the Act. Kartikeya v. Sarabhai v. CIT (228 ITR 163) SC.

**Section 2(22) (e): Loan or advance to share holder:**

Following types of payments made by a company are treated as dividend under this clause.

- Payment of any sum (whether representing a part of the assets of the company or otherwise) by way of advance or loan to a shareholder (and payment to concerns in which such share holder holds substantial interest);
- Any payment on behalf of a shareholder;
- Any payment for the individual benefit of a shareholder.
- Any of the above referred payments would be taxed under this sub-clause if following three conditions are fulfilled:
- The company should not be one in which the 'Public are substantially interested' within the meaning of section 2(18); In other words, this provision applies to closely held companies.
- The advance or loan is made to a equity share holder who beneficially owns at least 10 per cent of the equity capital or to a concern in which he is a member/ partner and is beneficially entitled to not less than 20% of income of the concern;
- The company should possess accumulated profits at the time it makes the payment. The payment can be deemed to be dividend only to the extent of such profits.

**Important Note:**

*This communication is intended to provide a general introduction and guidance on the subject matter and should not be regarded as a basis for taking decisions on specific matters. In such instances, separate advice should be taken.*

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