

TAXATION OF DIVIDENDS & LIQUIDATION OF COMPANIES

TAXATION OF DIVIDEND INCOME

(I) TAXABILITY OF DIVIDENDS IN HANDS OF SHAREHOLDERS AT NORMAL RATES

Prior to the amendments made by Finance Act, 2020, dividend income was chargeable to Dividend Distribution Tax (DDT) or more commonly known as Corporate Dividend Tax (CDT) at a flat rate of 15% plus applicable surcharge and cess. Accordingly, the dividend income was exempt in the hands of the recipient shareholders under section 10(34). However, Finance Act, 2020 has shifted the incidence of charge of tax on dividend income in the hands of recipient shareholders, thereby making the provisions of DDT/CDT redundant w.e.f. 01.04.2020. **Therefore, w.e.f. A.Y. 2021-22, dividend income shall be chargeable to tax in the hands of recipient shareholders at the normal tax rates.**

(II) SURCHARGE ON DIVIDEND INCOME RESTRICTED TO 15%

As per the Finance Act, 2020, in case of individuals and HUF, the surcharge on dividends and capital gains referred to in section 111A/112A shall not exceed 15%. The Finance Act, 2020 provides as under:

Where total income includes Capital Gains referred to in section 111A and /or section 112 and/ or section 112A and/or DIVIDEND INCOME then surcharge shall be as under:

	TOTAL INCOME	SURCHARGE
(i)	Does not exceed ₹ 50 lakhs	No surcharge
(ii)	Exceeds ₹ 50 lakhs but does not exceed ₹ 1 crore	10% surcharge on income tax
(iii)	Exceeds ₹ 1 crore but does not exceed ₹ 2 crores	15% surcharge on income tax
(iv)	Exceeds ₹ 2 crores	
	A. On tax computed on Capital Gains under section 111A & 112A and dividend income	15%
	B. On tax computed on Total Income – Capital Gains under section 111A & 112A and dividend income	

**If Total Income – Capital Gains under section
111A & 112A and dividend
income**

(a) is upto ₹ 2 crores	15%
(b) is above ₹ 2 crores but upto ₹ 5 crores	25%
(c) is above ₹ 5 crores	37%

W.e.f. A.Y. 2023-24, surcharge on capital gains referred to in section 112 is also capped at a maximum of 15% similar to section 111A, 112A and Dividend Income.

Illustration:

Determine the tax liability of Mr A (aged 42 years) for the A.Y. 2023-24 in following cases:

Particulars	Case 1	Case 2	Case 3	Case 4
Dividend Income	30,00,000	40,00,000	95,00,000	49,00,000
Capital Gain u/s 111A	10,00,000	20,00,000	55,00,000	3,00,000
Capital Gain u/s 112A	14,00,000	15,00,000	8,00,000	8,00,00,000
Other income	1,26,00,000	2,25,00,000	70,00,000	6,59,00,000
Total Income	1,80,00,000	3,00,00,000	2,28,00,000	15,11,00,000

Answer:

Assessment Year 2023-24				
Particulars	Case 1	Case 2	Case 3	Case 4
Tax on Capital Gain u/s 111A @ 15%	1,50,000	3,00,000	8,25,000	45,000
Tax on Capital Gain u/s 112A @ 10%	1,30,000	1,40,000	70,000	79,90,000
Tax on other income including dividend income	44,92,500	77,62,500	47,62,500	2,10,52,500
	47,72,500	82,02,500	56,57,500	2,90,87,500
Surcharge on income tax (See working Note)	7,15,875	18,89,455	8,48,625	86,74,130
Income-tax and Surcharge	54,88,375	1,00,91,955	65,06,125	37,761,630
Add: 4% cess	2,19,535	4,03,678	2,60,245	15,10,465
Tax liability	57,07,910	1,04,95,633	67,66,370	3,92,72,015
Tax liability (Rounded off u/s 288B)	57,07,910	1,04,95,630	67,66,370	3,92,72,100

Working Note: Computation of surcharge

Particulars	Case 1	Case 2	Case 3	Case 4
Total Income (excluding dividend income and income u/s 111A and 112A)	1,26,00,000	2,25,00,000	70,00,000	6,59,00,000

Total Income (including dividend income and income u/s 111A and 112A)	1,80,00,000	3,00,00,000	2,28,00,000	7,19,00,000
Applicable surcharge rate	15%	25% subject to a maximum of 15% on dividend income & income u/s 111A/112A	15%	37% subject to a maximum of 15% on dividend income & income u/s 111A/112A
Surcharge on tax on:				
Income u/s 111A @ 15%		45,000	1,23,750	6,750
Income u/s 112A @ 15%		21,000	10,500	11,98,500
Dividend income			—	
$\left(\frac{40,00,000}{2,65,00,000} \times 77,62,500 \right) \times 15\%$		1,75,755		
$\left(\frac{49,00,000}{7,08,00,000} \times 2,10,52,500 \right) \times 15\%$				2,18,554
Balance income @ 15% (including dividend income)			7,14,375	
$\left(\frac{2,25,00,000}{2,65,00,000} \times 77,62,500 \right) \times 25\%$	47,72,500 i.e., ₹ 7,15,875.	16,47,700		
$\left(\frac{6,59,00,000}{7,08,00,000} \times 2,10,52,500 \right) \times 37\%$				72,50,326
Total	7,15,875	18,89,455	8,48,625	86,74,130

(III) DETERMINATION OF PREVIOUS YEAR IN WHICH DIVIDEND IS TAXABLE IN HANDS OF SHAREHOLDERS

AS PER SECTION 8:

- Any deemed dividend under section 2(22)(a)/(b)/(c)/(d)/(e) shall be deemed to be the income of the previous year in which it is so distributed or paid, by the company.
- Any final dividend declared by a company shall be deemed to be the income of the previous year in which it is so declared at the AGM.
- Any interim dividend shall be deemed to be the income of the previous year in which it is received by the shareholders.

(IV) ALLOWABILITY OF EXPENSES FROM DIVIDEND INCOME

As per proviso to section 57, while computing dividend income, a deduction on account of interest expense is allowed subject to a maximum limit of 20% of the dividend income before such deduction. No expense except the above interest expense shall be allowed from Dividend Income.

(V) DEDUCTION UNDER SECTION 80M IF COMPANY RECEIVING DIVIDEND DISTRIBUTES DIVIDEND ONE MONTH PRIOR TO THE DUE DATE OF FILING OF RETURN

As per section 80M, where the gross total income of a domestic company includes dividends from:

- another domestic company
- a foreign company
- a business trust.

a deduction of an amount equal to the dividend distributed by the domestic company on or before the due date i.e., one-month prior to the due-date of furnishing of return of income under section 139(1) shall be allowed from the gross total income.

KEY NOTES:

- (a) Deduction is available only to a domestic company
- (b) Deduction shall be allowed only if the dividends are **distributed** and not just declared on or before the due-date.
- (c) As per Section 80A(2), the deduction under section 80M shall not exceed the amount included in gross total income.

To illustrate, let's say a domestic company A Pvt. Ltd. received dividends of ₹ 1,00,00,000 from another domestic company X Pvt. Ltd. for the year ended 31.03.2023. Also, A Pvt. Ltd. has incurred interest expense of ₹ 30,00,000 towards borrowed funds for the purpose of investing in shares of X Pvt. Ltd. Let us also say, that A Pvt. Ltd. declares **and distributes** a dividend of ₹ 90,00,000 to its shareholders on or before 30.9.2023.

Accordingly, tax liability of A Pvt. Ltd. shall be as under:

Particulars	Amount (₹)
Income from Other Sources	
Dividend Income	1,00,00,000
Less: Deduction as per proviso to section 57	20,00,000
Gross Total Income	80,00,000
Less: Deduction under section 80M	80,00,000
TOTAL INCOME	NIL

- (d) Section 115BBD provides for tax @ 15% on dividend received from specified foreign companies. The section overrides the entire Act and provides that no deduction shall be allowed in respect of any expenditure or allowance under any provision of the Act. **However, Section 80M is neither an expenditure nor an allowance. Accordingly, benefit of deduction under section 80M shall be allowed for the dividend income taxable under section 115BBD also.**

Illustration:

X Ltd. furnishes the following details for the A.Y. 2023-24.

Manufacturing Income	500 lakhs
Dividend Income received from:	

Particulars	A Ltd. (Indian Co.)	Mutual Fund	B Inc. [Foreign Co. (10% holding)]	C Inc. [Foreign Co. (45% holding)]
Dividend received	100 lakhs	20 lakhs	30 lakhs	50 lakhs
Collection charges	5 lakhs	4 lakhs	2 lakhs	3 lakhs
Interest on Borrowed Funds	30 lakhs	7 lakhs	20 lakhs	15 lakhs
Other expenses	2 lakhs	1 lakh	1.5 lakhs	1 lakh

X Ltd. declared a final dividend of ₹ 150 lakhs on 12th August, 2023. It distributed the same on 30th September, 2023. Compute the tax liability for X Ltd.

Answer:

- As per proviso to Section 57, no deduction shall be allowed from dividend income, other than deduction on account of interest expense.

Accordingly, collection charges or other expenses shall not be allowed to be deducted from the dividend income.

- It is given that X Ltd. holds 45% shares in C Inc. Accordingly, as per Section 115BBD, C Inc. is a specified company (a company in which the Indian company holds 26% shares or more). Such dividend income shall be taxable at the rate of 15% (plus applicable surcharge and cess) and **no deduction for any expenditure or allowance shall be allowed from such income, as per section 115BBD.**

Therefore, collection charges, interest expense and other expense incurred towards earning dividend income from C Inc. shall be disallowed.

- Further, the proviso to section 57 restricts the allowance of the interest expense upto 20% of the dividend income. Accordingly, interest to be disallowed shall be calculated as under:

Total interest expense	=	₹ 30 lakhs + ₹ 7 lakhs + ₹ 20 lakhs
	=	₹ 57 lakhs
Total dividend income	=	₹ 100 lakhs + ₹ 20 lakhs + ₹ 30 lakhs
	=	₹ 150 lakhs
20% of dividend income	=	₹ 150 lakhs × 20%
	=	₹ 30 lakhs

Computation of tax liability of X Ltd. for A.Y. 2023-24.

Particulars	Amount (₹ in lakhs)
Profits and Gains of Business or Profession	500
Income from Other Sources	
Dividend Income (100 + 20 + 30 + 50 - 40)	160
Gross Total Income	660
Less: Deduction under section 80M*	144

Total Income	516
Tax Liability	
Tax on 516 lakhs @ 22% assuming that company opts for section 115BAA	113.52
Add 10% surcharge	11.352
Add 4% cess	4.9949
	129.86688

* Deduction under section 80M is calculated on dividend received from A Ltd, B Inc. and C Inc. after deducting allowable interest expense. [100 lakhs + 30 lakhs + 50 lakhs – 36 lakhs = 144 lakhs]

- (e) **Deemed dividend under section 2(22)(a)/(b)/(c)/(d)/(e) is also considered for taking the benefit under section 80M.**
- (f) Dividend on both preference shares and equity shares shall be considered.

(VI) TDS ON DIVIDEND

Section 194 provides for a deduction of TDS at the rate of 10% on payment of dividend to a resident shareholder

No TDS shall be deductible if resident shareholder is an individual and

- (a) Dividend is paid by any mode other than cash AND
- (b) Dividend amount does not exceed ₹ 5,000

Note: Tax has to be deducted whether dividend is on equity shares or preference shares or dividend is deemed so under sections 2(22)(a)/(b)/(c)/(d)/(e).

(VII) SET OFF OF BUSINESS LOSS AGAINST DIVIDEND INCOME FROM SHARES HELD AS STOCK-IN-TRADE

Even where the shares are held as stock-in-trade, the dividend income on such shares shall be taxable under the head 'Income from Other Sources'. However, for the purposes of set off or carry forward of business losses, dividend income shall be deemed as 'Income under the head P/G/B/P. This was held in the case of Western States Trading Co. Pvt. Ltd. v/s CIT (SC) (1971).

To illustrate, let's say Mr. A holds shares as stock in trade and he has earned dividend income of ₹ 10,00,000 in A.Y. 2023-24. He also has brought forward business loss from A.Y. 2019-20 of ₹ 9,00,000 which can be carried forward upto A.Y. 2027-28 and can be set off against P/G/B/P income only. Dividend income is taxable under the head Income from Other Sources'.

Supreme Court held that Section 57 provides for the head of taxability of the dividend income but for all practical purposes where the dividend income is from shares held as stock-in-trade, such dividend income shall be deemed as Income under the head P/G/B/P. Accordingly, business loss of ₹ 9,00,000 shall be allowed to be set-off from the dividend income of ₹ 10,00,000.

(VIII) TAXATION OF DIVIDEND INCOME IN HANDS OF NON-RESIDENT AND FOREIGN COMPANY

As per Section 115A, dividend income shall be taxable at the rate of 20% in the hands of non-resident or a foreign company. No expenses including interest shall be allowed against dividend income as per section 115A. Section 195 provides for a deduction of 20% of dividend paid to Non-Residents or foreign company.

DEEMED DIVIDENDS

Deemed Dividend under sections 2(22)(a), 2(22)(b), 2(22)(c), 2(22)(d) and 2(22)(e) are taxable in hands of shareholders as per Finance Act, 2020.

SECTION 2(22)(a): ANY DISTRIBUTION OF ASSETS

Dividend includes any distribution of assets by a company to its shareholders to the extent the company possesses accumulated profits, whether capitalised or not.

Note 1: When a company distributes assets to shareholders then, it amounts to GIFT and as per the provisions of section 47 no capital gains shall arise to the company.

Cost of acquisition of such assets to the shareholders shall be the cost of such assets to the company.

Note 2: Central India Industries Ltd. (SC)

When assets are distributed under section 2(22)(a), 2(22)(c) and 2(22)(d), the market value of the asset on the date of distribution has to be taken for computing the dividend.

SECTION 2(22)(b): DISTRIBUTION OF DEBENTURES, ETC.

DIVIDEND INCLUDES:

- (i) any distribution to its shareholders by a company of debentures, debenture-stock or deposit certificates in any form, whether with or without interest and
- (ii) 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 OF ASSETS IN THE EVENT OF LIQUIDATION

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

Note 1: The **FMV of assets on date of distribution** shall be considered for determining the deemed dividend.

Note 2: Distribution is deemed as dividend **to the extent of accumulated profits**, whether capitalised or not, **immediately before liquidation**.

Note 3: **Section 46(1):** Notwithstanding anything contained in section 45, **where the assets of a company are distributed** to its shareholders on its liquidation, such **distribution shall not be regarded as a transfer** by the company.

Note 4: **Section 46(2):** Where a shareholder on the liquidation of a company receives any money or other assets from the company, then he shall be chargeable to income-tax under the head capital gains and the sales **consideration for the purposes of section 48 shall be as under:**

Moneys Received

Add: Market value of the assets received as on the date of distribution.

Less: Amount assessed as dividend under section 2(22)(c)

Sales consideration for the shares in the liquidating company

Note 5: **Section 2(42A):** For determining the nature of capital gains arising from the shares in liquidating company, the **period subsequent** to the date on which the **company goes into liquidation shall not be considered**.

Note 6: Where the capital asset became the property of the assessee on **distribution of capital assets by a company on its liquidation** and the shareholder has been assessed to income-tax under the head "Capital Gains" in respect of that asset under section 46, **the cost of acquisition of the asset will be the FMV of the asset on the date of distribution.**

SECTION 2(22)(d): REDUCTION OF SHARE CAPITAL

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

Notes: G. Narasimhan (Supreme Court)

The Supreme Court held that the amount distributed by the company on reduction of its share capital has two components, namely:

- (i) Distribution attributable to accumulated profits and
- (ii) Distribution attributable to the capital.

The Supreme Court held that the amount received on reduction of capital as reduced by the amount deemed as dividend is the sale proceeds for computing capital gains on reduction of share capital. Therefore, the sale price of shares reduced shall be as under:

FMV of assets received on reduction	XXXX
Add: Money Received	XXXX
Less: Amount deemed as dividend under section 2(22)(d)	XXXX
Sale price of shares reduced	XXXX

SECTION 2(22)(e): LOANS & ADVANCES BY CLOSELY HELD COMPANY DEEMED AS DIVIDEND

DIVIDEND INCLUDES

- any payment by a closely held company
- of any sum by way of loan or advance to
 - (i) a shareholder being the beneficial owner of shares
 - (ii) holding not less than 10% of voting power
- or
 - (i) to any concern
 - (ii) in which such a shareholder
 - (iii) is a member or a partner
 - (iv) and in which he has a substantial interest
- or
 - (i) to any person
 - (ii) on behalf of or for the individual benefit of such a shareholder
- **to the extent to which the company possesses accumulated profits.**

Notes:

1. CBDT has clarified that trade advances, which are in the nature of commercial transactions would not fall within the ambit of the word 'advance' in section 2(22)(e).

For example, the following trade advances/commercial transactions would not get covered under section 2(22)(e):

- i. Advance made by a company to a sister concern and adjusted against the dues for job work done by the sister concern.
 - ii. Advance made by a company to its shareholder to install plant and machinery at the shareholder's premises to enable him to do job work for the company so that the company could fulfil an export order.
 - iii. Floating security deposit given by a company to its sister concern against the use of electricity generators belonging to the sister concern. The company utilised gas available to it from GAIL to generate electricity and supplied it to the sister concern at concessional rates.
2. **G. Narasimhan (Supreme Court): For the purpose of section 2(22), accumulated profits get reduced by the amount deemed as dividend under section 2(22)(e) even if no adjustment is made in the books of account.**
 3. **The fact that the loan or advance is repaid does not make a difference in the applicability of section 2(22)(e).**
 4. Section 2(22)(e) is also attracted if company charges market rate of interest on the loans / advance given to the shareholder.

Gopal & Sons (HUF) v. CIT (2017) (SC)

In the instant case, loans were given to the HUF. There was some dispute as to who was the shareholder -the Karta or the HUF as share certificates were issued in the name of the former but the annual return mentioned the latter. The Court observed that in either scenario, section 2(22)(e) would be attracted. If the HUF was the shareholder, as it held more than 10% shares, situation was covered. If

the Karta was the shareholder, the HUF would be the concern in which the Karta has substantial interest. The Supreme Court, accordingly, held that the loan amount is to be assessed as deemed dividend under section 2(22)(e).

SECTION 2(22) ALSO PROVIDES THAT DIVIDEND SHALL NOT INCLUDE

- (i) Any advance or loan made to a shareholder or a concern by a company in the ordinary course of its business where the money lending is substantial part of the business of the company.
- (ii) Any dividend paid by a company which is set off by the company against the whole or any part of the loan which has been deemed as dividend under section (22)(e).
- (iii) Any distribution made in accordance with section 2(22)(c)/(d) in respect of preference shares.
- (iv) Any payment made on buy-back of shares in accordance with Companies Act.
- (v) Any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).

EXPLANATION 2A TO SECTION 2(22): ACCUMULATED PROFITS IN CASE OF AMALGAMATION

In the case of an amalgamated company, the accumulated profits, whether capitalised or not, or loss, as the case may be, shall be increased by the accumulated profits, whether capitalised or not, of the amalgamating company on the date of amalgamation.

Illustration 1: POSITION PRIOR TO AMALGAMATION

Balance Sheet of A Ltd. Before Amalgamation

Sources of Funds	Amount (₹ in crores)
Share Capital (Includes ₹4 crores Bonus shares issued out of Reserves and ₹1 crore bonus shares issued out of Security Premium)	12
Security Premium	2
Reserves & Surplus	10
Total	24
Application of Funds	
Non-current Assets	14
Current Assets	10
Total	24

Balance Sheet of B Ltd. Before Amalgamation

Sources of Funds	Amount (₹ in crores)
Share Capital (Includes ₹7 crores Bonus shares issued out of reserves and ₹2 crores Bonus shares issued out of security premium)	50
Security Premium	4
Reserves & Surplus	1
Total	55
Application of Funds	
Non-current Assets	34
Current Assets	21
Total	55

POSITION AFTER AMALGAMATION

A Ltd. is amalgamated into B Ltd. The shareholders of A Ltd. are allotted shares of ₹24 crores and balance sheet of B Ltd. after amalgamation is as under:

Sources of Funds	Amount (₹ in crores)
Share Capital (Includes ₹7 crores Bonus shares issued out of reserves and ₹1 crores Bonus shares issued out of security premium. ₹ 24 crores shares issued on amalgamation)	74
Security Premium	4
Reserves & Surplus	1
Total	79
Application of Funds	
Non-current Assets	48
Current Assets	31
Total	79

As per Explanation 2A, the accumulated profits of B Ltd after amalgamation shall be as under:

$$\begin{aligned}
 \text{Accumulated Profits} &= 1 \text{ crore} + 10 \text{ crores} \\
 &= 11 \text{ crores} \\
 \text{Accumulated Profits whether capitalized or not} &= (1 \text{ crore} + 7 \text{ crores}) + (10 \text{ crores} + 4 \text{ crores}) \\
 &= 22 \text{ crores}
 \end{aligned}$$