THE DILEMMA OF DIVIDEND TAXATION IN A DEVELOPING ECONOMY: THE INDIAN EXPERIENCE

J V M SARMA

NO. 6 FEBRUARY, 1991

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1. Introduction

For a long time, the controversy over taxing corporate dividends at rates different from retained earnings, has remained unresolved. However, in recent years there has been a revival of interest in the tax treatment of dividend incomes.

To recap the polemics, the proponents of tax neutrality view companies as agents of shareholders and therefore, argue that tax differentiation between distributed and undistributed profits violates the principles of equity as also affects efficient allocation of resources in the economy. The principle of equity is violated as firstly, tax liabilities of similarly placed shareholders belonging to different companies might not be equal, and secondly, even for the same company, retained profits are taxed at rates different from those applicable to dividend incomes of shareholders in different brackets. The efficiency argument brings out the distortionary effects engendered by the tax discrimination, in vital decision-making processes of corporations. These arguments imply that in the present system of two-tier taxation of corporate incomes found in many countries, some degree of harmonisation is essential between the company level taxes and taxes on dividends at the individual's level.

In contrast, the supporters of differential tax treatment prefer to view corporations as entities separate from shareholders and thus see no justification for alleviating the double tax burden on dividends. The greatest attraction of the separate entity view has been that it helps simplifying the tax administration considerably by removing the need for complication tax harmonisation procedures.

The separate entity view has an added appeal for the governments of developing countries, for, by allowing differential taxation of dividends and retained profits, it affords the much needed flexibility to attune tax policy to the developmental objectives such as stepping up of corporate savings, maintenance of incomes equality, reduction of conspicuous consumption by shareholders, control of inflation and maintenance of reasonable wage-price stability. Thus, despite the theoretical edge of the agency viewpoint, many countries prefer the non-neutral tax systems based on the separate entity view, particularly, the Classical system.

This does not, however, mean that the separate entity view has prevailed over the agency principle. In fact, experience in some of the countries that have adopted the `Classical' system tends to prove the contrary. In these countries, over the years, there appears to be a growing awareness of the distortionary effects created by the adoption of non-neutralised tax systems. Consequently, there have been signs of a slow but steady transformation in their tax policy towards neutralisation of the tax burden between dividends and retained profits.

The Indian experience during the past four decades as a case is work considering. Towards the end of fifties, the partial integration system inherited from the British at the time of Independence (1947) was given up in favour of the `Classical' system. In fact, the government even went to the extent of levying additional taxes on dividends at companies' level. The nurturing of the tax bias against dividends continued till late sixties. The ensuing decades, however, have witnessed a gradual backtracking of the policy and toning down of the tax discrimination to some extent. Not only the additional dividend taxes were removed, but also tax reliefs in the form of exemptions were allowed on dividend incomes.

Thus, although the governments in developing countries might be attracted by the flexibility of the non-neutral tax systems, in the long run, the equity and efficiency distortions created by such systems cannot be overlooked. The purpose of the study is to take a close look at the gradual metamorphosis of the Indian tax policy in respect of corporate dividends in some detail. The Indian experience can provide valuable lessons for the developing countries with similar economic formats.

Depending upon the overall slant in the dividend tax policy, the 43 year period since Independence divides itself neatly into three parts. 1. The initial phase (1947-1955), during which the partial integration system inherited from the British was allowed to continue with minor changes; 2. The formative and experimented phase (1956-1968), when the Classical system was adopted with a steep bias against dividends, which was accentuated by the levy of excess dividend taxes and; 3. The present phase starting around 1969 that has been witnessing a gradual narrowing down of the double taxation bias against dividends by rising exemptions on dividend incomes.

2. The Initial Phase (1947-1955)

A. Main Taxes on Companies

Although the tax system inherited from the British by the Government of India in 1947 was fairly developed, it was caught up between the two divergent viewpoints mentioned above, and therefore, lacked a clear direction with regard to dividends.

The system consisted of two main components, an income tax and a super tax, the former reflecting the agency view and the latter, the separate entity view.

Since the income tax component was deemed to have been paid on behalf of the shareholders, a credit was allowed while assessing them for the personal income tax by a procedure known as the `grossing-up´ of dividends. Accordingly, the income tax paid by companies was apportioned between distributed and undistributed profits in the same ratio and the amount of tax attributable to dividends was credited to shareholders. While assessing the shareholders for individual income tax, their respective tax liabilitiesd were determined based on dividends `grossed-up´ for the company level income tax. The `grossing-up´ dividend per unit of actual dividend was computed as **1/(1-t)** where **t** was the effective company income tax rate. In the end, it was seen that the undistributed profits were charged at the company income tax rate while dividends were taxed at personal income tax rates.

The other major component of the system, namely, the super tax was nevertheless, meant to be borne and absorbed entirely by companies in keeping with the separate entity view. In fact, it is for this reason the super tax was regarded as the proper Corporation tax.

B. Penal Tax on Dividends

An unusual development in the tax system relating to corporate dividends was the levy of an additional tax in 1948 on dividends in excess of current profits (nett of income and super taxes), along with a rebate for restrained distributions. This tax was introduced primarily to restrain companies from passing on their wartime accumulated profits to their shareholders, which would have added to the inflationary tendencies in the economy. Also, the industrial sector was experiencing the postwar recession. Besides the negative discouragement by way of penal tax, positive measures in the form of a tax rebate with a view to encouraging companies to plough back profits became necessary to step-up the investment activity in the economy.

The additional tax liability was computed as an excess of equity plus preference dividends over and above current profits minus deductions and exemptions, after payment of income tax and super tax. (The combined rate then was 43.75 per cent). The `excess dividends' computed thus, were taxed at a rate equivalent to the difference between the maximum income tax rate allowed by the law and the rate actually borne by the company in question. The idea was to disqualify such a company for tax concessions usually given to Indian public limited companies. The tax rebate for restrained dividend payments was 6.25 per cent. Initially, companies with income below Rs. 25,000 were exempted from the additional levy, though the rebate for restrained dividends was extended to them also. However, from 1949 small companies were also subjected to the additional tax. The penal tax was continued till 1955-56.

C. Personal Income Tax on Dividends

Dividends, as part of personal incomes, were also liable to the two taxes at the individual level, income tax and super tax, the latter being levied on incomes above Rs.25,000. The income tax was deducted at source at a standard rate in force, (generally 20 per cent) while super tax was not deducted at source except for non-residents. The difference between the actual tax liability and liability `at source', was made good at the time of assessment of the shareholders.

An important aspect of personal taxation was the separate treatment of `earned' and `unearned' incomes until as late as 1969-70. This differentiation was introduced a few years before Independence, largely in line with the prevailing practice in other countries such as the United States. Various justifications were advanced later for such a differentiation on the grounds of equity, higher taxable capacity of unearned incomes and so on. However, the objective was to tax at lower rates, those who `earn' their incomes, that is, sweat and toil for it in contrast to those who derive their incomes from property and investments, that is, without making any direct effort. Dividends, needless to say, came under the latter category.

That the tax burden underlying the system was not neutral between dividends and retained profits should be obvious. Dividends were subject to double taxation as they were liable to company income tax and super tax at the company level, and were further liable to personal income tax and personal super tax (at the rates applicable to unearned incomes) in the hands of shareholders. The only reliefs from the double taxation were through the `grossing-up' arrangement.

The `grossing-up' system could provide only a partial relief from the double taxation of dividends, since the facility was confined to the income tax component. In fact, the tax differential left unfilled by the income tax component was negligible compared to that caused by the levy of super tax. It is doubtful if the `grossing-up' could mitigate fully, the double tax burden caused by even the income tax component. For, the average marginal income tax rate on shareholders' income differed very much from the standard rate on undistributed profits, which was pegged at the highest rate on the income tax ladder. The differential tax burden was accentuated by a tax rebate of 6.25 per cent for restrained dividend payments.

This dichotomous state of affairs was left almost undisturbed through the initial years of the post-Independence period. Even the Taxation Enquiry Commission that was assigned the task of streamlining the tax system in 1953 refrained itself from recommending any drastic changes in respect of dividend taxation as it felt that since "both the shareholders and the market had become accustomed to these refunds of income tax (by the `grossing up´ practice), their discontinuance might adversely affect a large number of persons and might also act as a disincentive to equity investment."

2. The Experimentation Phase (1956-1968)

The later half of fifties witnessed extensive changes in the tax system. With the launching of the Second Five Year Plan on an ambitious scale which provided for a core public enterprise sector, the tax system was looked upon as a vital instrument for mobilising resources to carry out the Plan objectives. Among the numerous steps undertaken to rationalise and rejuvenate the tax system, two of them pertained to corporate dividends. They were: (a) the abolition of `grossing-up´ of dividends in 1959-60, and (b) the revival of additional tax on dividends.

A. Abolition of `Grossing-up´ Practice

An important change with regard to the income tax component was the abolition of `grossing-up´ of dividends in 1959-60. As noted above, with all its complicated computations the grossing-up practice could not neutralise the tax differentiation between dividends and retained profits. The very fact that the arrangement was not extended to super tax and other taxes, resulted in only a partial adherence to the agency principle of Corporation taxation, and therefore, a reflection on government's dilemma about which way to swing between agency and separate entity theories. But there were more serious considerations that led to its abolition. The main difficulty was the linking of the rate of `grossing-up' of net dividends with the actual tax rate applicable to the dividend-paying company. In the words of the then Finance Minister; "For one thing the rate of grossing depends on the effective rate at which the company's profits are initially subjected to tax. The effective rate in its turn depends upon the composition of the income of the company. The dividends themselves may be paid out of reserves accumulated over some years, which again complicates the determination of the effective rate at which the profits have been taxed. Further, the assessments of shareholders have to wait till the completion of the assessments of the companies. All these led to considerable inconvenience to all concerned..." (Budget Speech, Central Budget (1959-60), New Delhi). Accordingly, `grossing-up', the last remnant of `agency' theory in India, was abolished. Since then the `Classical' system has been in force. The impact of the abolition of `grossing-up' on tax differential was claimed to have been minimised by `suitably adjusting' the tax rates.

The second important change was the restructuring of the super tax on excess dividend distributions. Incidentally, the super tax rate structure itself underwent many changes to meet the diversified industrial base. Apart from the existing distinction between companies according to (a) size of income, and (b) whether, a company is that in which public is substantially interested, or not interested, further distinctions were introduced, the criteria being (c) the main activity a company is engaged in (financial, insurance, `industrial' or `priority´ activities as defined in Finance Act 1964), as also (d) the nationality factor (Indian or foreign). The rate also differed according to the source of income (inter-corporate dividends, royalties, technical fees and so on). But a crucial development of super tax law in respect of dividend payments was the levy of excess dividends tax.

B. Excess Dividends Tax

With the introduction of this tax in 1956, the dividend tax policy for the first time, was claimed to have been geared to the needs of planned development effort with a commitment to mixed economic frame. The tax was formulated with a view to encouraging corporate savings and to making private sector companies self-sufficient in financing their investment needs. It was believed that such a policy would reduce competition for bank credit from private sector companies, thus making it available to public sector undertakings to finance their heavy investments envisaged in the Five-Year Plans. Dividend distributions exceeding the prescribed limit were subject to the excess super tax. The limit for dividend payments was prescribed in terms of capital employed unlike in terms of total income as in the case of earlier `penal´ income tax on dividends. Also, a certain progression was introduced in the tax rate structure.

The additional tax was criticised on many accounts. For instance, it was brought out that the excess dividends tax, by linking the dividend payments to `capital´, was biased against firms that did not need a large capital base to operate, such as those producing consumer goods, compared to firms with larger capital base.

C. Dividends Tax

In view of the mounting criticism, the excess dividends tax was temporarily discontinued from 1960-61. But the desire "to discourage the dissipation of these resources in higher dividends" was again felt strongly during 1964-65 resulting in its revival. (`The resources' mentioned in the quote referred to the tax savings as a result of a new 10 per cent rebate allowed to `priority' industries in respect of income tax and super tax and also in respect of surtax). To avoid complications, companies belonging to the `non-priority' sector were also brought under this tax. The tax rate was 7.5 per cent on the whole of equity dividends declared. Yet, new companies were allowed an exemption up to 10 per cent of equity capital for five years after the maiden declaration of dividends, probably in view of the criticism on the previous excess dividends tax that it penalised companies that could not distribute dividends in the past years. But to qualify for this exemption a company was required not to have declared any dividends during the first five consecutive years of operation.

D. Bonus Shares Tax

A tax on bonus shares also featured in the Indian income tax system during 1956-57 through 1966-67 as a supplement to the excess dividends tax. Also for one year, 1964-65 they were taxed as capital gains.

E. Taxation of Inter-Corporate Dividends

Until 1953-54, inter-corporate dividends did not receive any special treatment under the income tax law. They were subjected to company taxes at both the levels of the dividend paying company as well as the dividend receiving company. The one factor that prevented the Government from exempting inter-corporate dividends from company taxes was a suspicion that companies might take advantage and avoid taxes and consequently might lead to concentration of economic power. Even the Taxation Enquiry Commission was against exemption of such dividends. Finally, this malady of `multiple' taxation of dividends came to the notice of the Government in 1953-54 when a mild rebate was granted to new undertakings engaged in certain industries in respect of dividends received by them.

The first major step in favour of inter-corporate dividends was in 1957, when dividends from a subsidiary company were taxed at a lower rate of 10 per cent than others. The tax rates on inter-corporate dividends since then were varying almost every year. During the period from 1957 to 1969 the tax rate on income derived from subsidiary companies remained at 10 per cent. However, in 1962 the tax rate was lowered to 5 per cent. In the case of income derived from Indian companies other than their subsidiaries the tax rates differed between (a) domestic, widely held companies with total income not exceeding Rs. 25,000, (b) other domestic companies, and (c) non-domestic companies.

3. The Modern Phase (1969-)

A. Abolition of Dividend Taxes

From 1969 onwards, a marked reversal of the tax bias against dividends can be observed. The question of continuing with the dividends tax was examined at length by the Bhootalingam Committee in 1967. The Committee, `on balance of considerations' recommended the abolition of the tax, as `it seems clear that no identifiable good comes out of dividend tax'. The arguments put forth by the Committee for the abolition of the tax were mainly on three grounds: First, the Committee doubted whether the objective of dividend tax had been realised or was 'even capable of realisation', and that the response to the tax might even be lower because of the abolition of bonus shares tax in the year 1966. Second, the Committee questioned the rationale for continuing with the tax, reiterating the arguments against dividend restrictions in general, that they might not always result in increased investments and that removal of restrictions may not always end-up in conspicuous consumption by shareholders. The chance of corporate savings not showing-up as new investment is greater in India where "there were some restrictions on the use of retained profits, (and) companies were positively discouraged from investing in other companies or even diversifying their own activities." Further, the Committee pointed that dividend tax also restricted the freedom of shareholders to re-invest their dividend incomes more efficiently. Third, the Committee questioned the design of tax on the ground that linking dividends to capital was irrational and compelling all companies uniformly to retain profits regard less of their relative needs as unjust.

In view of the recommendations, the dividends tax was finally abolished in 1968, once and for all. Yet, the differentiation under the 'Classical' income tax structure, has remained in favour of profit retentions.

Also, after 1964-65, the income and super taxes were merged into one tax at the combined rate of 50 per cent with little variation during the later years.

B. Personal Income Tax on Dividends

Regarding the personal income tax, apart from the merger of income and super taxes, the separate treatment of 'earned' and 'unearned' incomes was also abolished from 1969-70.

While at the company's level the dividend taxes were abolished, at the individual's level dividend incomes (from Indian companies) up to a certain limit were exempt under Section 80L. This limit was initially fixed at Rs. 500 in 1968, but was gradually raised to Rs. 10,000 by 1989-90. Also, to encourage investments in shares, income tax deductions are granted in respect of investments in certain specified shares up to Rs. 20,000.

C. Abolition of Bonus Shares Tax

The levy of a bonus shares tax was made necessary by the particular form of excess dividends tax chosen. By linking `excess dividends' to paid-up capital a loophole had been created. A company could, by issuing bonus shares, expand its `capital' base and thereby could distribute a larger portion of profits in the subsequent years without attracting excess dividends tax. To fill this loophole, bonus shares tax became necessary. The tax could have been avoided either by defining the limit for excess dividends as a share in profits or by mere extending the definition of `capital' base to include reserves that are potential sources for bonus share issues, which would have also satisfied some critics. The tax was abolished in 1966-67.

D. Abolition of Inter-corporate dividends

Thanks to the industrial recession in 1964-65, inter-corporate dividends are exempted from company tax since then. However, levy of income tax continued. With the integration of income and super taxes in 1965-66 a provision was made not to tax inter-corporate dividends at rates higher than 25 per cent.

5. Summary and Conclusions

The above brief survey of selected aspects of income tax system shows that taxation of dividends has been a complicated affair in India and that several taxes impinge on dividends in a variety of ways at different levels. The main developments can broadly be summarised as follows :

Until 1959-60 the system was characterised by attempts at partially integrating the taxes at the two levels; companies and their shareholders by the 'grossing-up' practice. From 1960-61, the system was switched over to pure 'Classical' type. Superimposed on this broad system were the occasional dividend taxes that accentuated the relative tax burden on dividends. Three forms of taxes were experimented with: the 'penal' tax, the 'excess dividends tax' and the 'dividends tax'. While it is difficult to assess the severity of the 'double' taxation on dividends as well as its impact on distributions without taking into account the rate structures prevailing at each point of time, the imposition of excess dividends tax in 1956, quickly followed by the abolition of 'grossing-up' can be regarded as a severe step. On the other hand, the penal tax/ rebate system along with the 'grossing-up' could have been the least severe.

The resultant distortionary effects of the tax differentiation became visible over the years. The heavy tax bias against dividends restricted the choice of investors leading to inefficient allocation of funds in the economy. Consequently, there has been a growing dissension against the double taxation of dividends. The discriminatory tax policy also curtailed the ability of small and new companies to raise funds through equity markets and this trend contributed to the growth of monopolistic forces in the economy.

In view of this growing discontentment against tax discrimination, successive governments had to relent. This has resulted in making continuous efforts to remove the tax bias against dividends. Not only the excess taxes have been repealed, but also dividend incomes of shareholders up to certain limits have been exempted (under Section 80L of the Income Tax Act). Also notable, is the gradual rise in the exemption limit on dividend incomes. The favourable response of the capital market to these measures and the spurt in the public interest in the equity market in recent times, cannot be shrugged off as a transitory phenomenon. Thus the lessons are clear.

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