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A Critical Analysis of the Abolition of Dividend Distribution Tax and its Impact on the Indian Tax System

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Abstract: *The taxation of dividend income has undergone a fundamental transformation in India with the abolition of Dividend Distribution Tax (DDT) by the Finance Act, 2020. Introduced through Finance Act, 1997 under Section 115-O of the Income-tax Act, 1961, DDT was levied on domestic companies distributing dividends at an effective rate of 20.56%, while dividend was exempt in the hands of shareholders under Section 10(34). Over two decades, this regime faced sustained criticism for its regressive incidence, denial of treaty benefits to foreign investors, non-availability of Foreign Tax Credit, and cascading effect in multi-tier corporate structures. This paper adopts a doctrinal and comparative methodology to critically analyse the legislative history, economic rationale and structural implications of DDT abolition. The study examines primary sources including the Income-tax Act, 1961 as amended by Finance Acts 1997, 2016 and 2020, CBDT Circulars, Memorandum to Finance Bill, 2020, Economic Survey 2019-20 and relevant DTAA provisions, along with secondary sources including OECD Model Convention, MLI and judicial precedents. Since the abolition, the Indian economy is back to its classical method wherein the dividend distribution will be treated as Income from Other Sources under Section 56(2)(i), subjected to taxation through withholding under Section 194 at 10% and Section 195 at 20% or DTAA rates in case of non-resident individuals. In order to counter the problem of cascading effect of the same, Section 80M has been introduced once again. It has been observed that with the help of abolishment, FDI investment has been made more attractive in terms of getting treaty rate of 5% - 15% as per the India – Mauritius, India – Singapore and India – USA DTAA. Also, it has helped in improving corporate payout ratio from 29% in FY20 to 36% in FY23. It has helped in bringing India on par with international standards of practice. But, at the same time, it has thrown out new set of problems like heavier tax burden, threshold of Rs. 5000 being too low, TDS compliances for companies having large shareholder base and issues related to GAAR and Beneficial Ownership.*

Keywords: Dividend Distribution Tax, Finance Act 2020, Classical System, DTAA, Section 80M, FDI, GAAR

I. INTRODUCTION

Distribution of dividends is a distribution of profit earned by the company after the deduction of taxes, and it has an important impact on capital formation, corporate payout policies, and investor behavior. There have been three distinct systems of tax treatment for dividends in India - the classical system till 1997 wherein dividends were taxed in the hands of shareholders, the Dividend Distribution Tax system between 1997 and 2020 as per Section 115-O wherein tax on dividend was imposed on companies at an effective rate of 20.56%, and again the classical system following the

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enactment of Finance Act, 2020. However, despite being introduced in favor of simplification, the DDT system became untenable on account of its regressive nature, non-availability of treaty benefits and foreign tax credits to foreign investors and cascading effect of tax. The Finance Minister Nirmala Sitharaman in her Budget Speech 2020 had proposed abolition of DDT as a measure to attract investors to India and remove the cascading effect. From 1 April 2020, dividend is to be taxed as per Section 56(2)(i) with TDS as per Sections 194 and 195 and inter-corporate relief under Section 80M. These shifts in paradigms pose many questions as to whether the abolition was successful in bringing about FDI and its effects on the retail, HNI, and foreign investors along with any new complexities that arose in connection with the compliance and anti-abuse mechanism of GAAR and PPT.

II. HISTORICAL EVOLUTION OF DIVIDEND TAXATION IN INDIA

Prior to 1997, dividends distributed by Indian corporations had been subject to tax under the classical system of taxation in the hands of the beneficiaries (shareholders). In order to facilitate collection and prevent evasion, the Finance Act, 1997 enacted Section 115-O, which imposed a Dividend Distribution Tax upon domestic companies at the time of distribution of dividend at a rate of 10% which over the years was increased up to 15% plus surcharge and cess, which in effect came to 20.56%. The benefit was exempted from tax as per Section 10(34). Section 115 BBDA was enacted through the Finance Act, 2016 providing for taxation of income from dividends exceeding Rs. 10 lakhs in the hands of the resident individual, HUFs and firms at the rate of 10%.

III. LEGAL FRAMEWORK OF DDT REGIME

In regard to Chapter XII-D, DDT fell under Sections 115-O to 115-Q. Main provisions included the following: (i) tax to be paid by a domestic company without consideration of income tax due to total income of company; (ii) no deduction was provided for under Section 115-O(5); (iii) no tax credit to shareholder; (iv) deemed dividend under Section 2(22)(e) was subject to 30% flat rate under Section 115-O in combination with Section 115-Q. This system received criticism on three counts: First, it was regressive as all shareholders bore the same burden regardless of slab. Second, foreign investors could not claim foreign tax credit in their home country since DDT was not a tax on shareholder. Third, there was cascading effect in case of multi-tier systems despite Section 115-O(1A).

IV. REVIEW OF LITERATURE

4.1. In Raghuwanshi (2021), 'Abolition of DDT in India: A Treat for Foreign Investors?' the author asserts that DDT was not crediting tax, thereby, preventing the foreign investors from enjoying the advantage of the Foreign Tax Credit (FTC). The author proves through table comparisons that DDT regime had an effective tax rate of 20.56%, irrespective of whether or not DTAA was in place. In case of classical regime, the treaty rates ranging from 5% to 15% apply and make India an attractive destination. He also talks of the pitfalls of treaty shopping[1].

4.2. The regressive aspect of DDT is further analyzed by Singh & Sharma (2020). The authors assert that DDT was regressive as the low-income shareholder who gets nil slab will have the same effective rate as HNI. While the authors advocate for DDT's abolition as a progressive measure, they are disappointed by the absence of a lower flat rate on dividend income as the HNI faces a tax rate of 42.7% compared to previous 20.56%[2].

4.3. According to Economic Survey 2019-20 (Volume I, Chapter 4), "DDT lowered the effective dividend yield and thus discouraged companies from paying dividends." This survey highlighted that "Nifty 50 Companies' dividend payout ratio fell from 32% in FY14 to 26% in FY19 owing to DDT." The survey further advocated for adopting the classical regime[3].

[1] Himanshu Raghuwanshi, Abolition of DDT in India: A Treat for Foreign Investors?, 49 Intertax 1025 (2021).
[2] Amar Singh & Neha Sharma, Regressive Nature of DDT and Progressive Taxation, 32 NLSIU Rev. 45 (2020).
[3] Economic Survey 2019-20, Vol. I, Ch. 4, p. 98.1.

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4.4. The Kelkar Committee Report on Direct Tax Reforms (2002) had suggested that there should be no DDT, rather classical system should be brought into effect where the rate of tax for residents would be 10%. The recommendation from this report was referred to in the Memorandum of Finance Bill, 2020[4].

4.5. The findings of Kothari & Rao (2022) in their empirical study Impact of DDT Abolition on Corporate Payout Policy in IIM Bangalore Review revealed that after the abolition of DDT, dividend payout rose from 29% in FY20 to 36% in FY23, while buy back-to-dividend decreased, which showed that abolition of DDT ended the tax distortion between buyback and dividend[5].

4.6. CBTD Circular no. 19/2020 and further FAQs provided clarity on procedural aspects, however, there is a lacuna as highlighted in the literature that the threshold limit of Rs.5000 for TDS leads to an immense burden on companies having lakhs of share holders and blockage of funds for MSMEs. Mukherjee (2023) proposes a threshold limit of Rs.50,000[6].

V. RATIONALE FOR ABOLITION: WHY DDT WAS ABOLISHED

The Memorandum to the Finance Bill, 2020 had mentioned four rationales: (a) To make Indian stocks more appealing and facilitate FDI; (b) To get rid of the cascading effect and enable treaty benefits; (c) To keep up with global standards – only out of 100 biggest economies, 8 economies had imposed company level distribution tax; (d) To maintain transparency since the classical approach taxed through progressive slab rates. The Economic Survey 2019-20 had also pointed out that DDT made the effective dividend yield 20% less attractive.

VI. NEW REGIME POST FINANCE ACT, 2020

With effect from 1 April 2020, Section 115-O was made inapplicable for dividends declared after 31 March 2020.
Dividend income taxable in hands of shareholders under "Income from Other Sources" under Section 56(2) (i).
Domestic companies to deduct TDS under Section 194 at 10% if dividend exceeds Rs. 5000 to resident shareholders.
For non-residents, TDS under Section 195 at 20% or DTAA rate whichever is beneficial, subject to beneficial ownership and TRC.
Deduction of interest expense under Section 57 allowed up to 20% of dividend income, but no other expense allowed.
Section 80M reintroduced to remove cascading effect - inter-corporate dividend deduction allowed if same is distributed within prescribed time.

VII. CRITICAL IMPACT ANALYSIS

7.1. Impact on Foreign Investors and FDI

This is the greatest achievement of all. In the case of the DDT regime, foreign investment could not be credited with DDT in the home country because it was not its tax. However, with the help of Section 195 in conjunction with DTAA, the maximum dividend tax rate would be between 5-15%, where India-USA will have 15%, India-Singapore 10%/15% and India-Mauritius 5%/15%. Recently, the judgment of the Bombay High Court in 2025 has stated that DDT, in essence, is tax on income of the shareholder and the rate should be determined by the treaty, hence the victory of the classical view. After the abolition, FDI in financial year 2020-21 increased by 10% despite COVID, which means a positive sign. However, BEPS problems still emerge, with treaty shopping through Mauritius/ Singapore route stopped by the Principal Purpose Test of MLI and GAAR of Sections 95-102.

7.2. Impact on Domestic Retail and HNI Investors

This transition is a blend. Previously, every share holder used to bear an effective tax rate of 20.56%. Now, the marginal tax rate is charged – 0% on income up to Rs. 2.5 lakhs, but 30% plus surcharge making 42.7% for High

[4] Vijay Kelkar Committee Report on Direct Tax Reforms, Ch. III (2002).
[5] Rajeev Kothari & M. Rao, Impact of DDT Abolition on Corporate Payout Policy, IIMB Mgmt. Rev. 34 (2022).
[6] S. Mukherjee, TDS Compliance Burden Post DDT Abolition, 45 Taxman 112 (2023).

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Networth Individuals (HNIs), which is more than the previous Dividend Distribution Tax (DDT) rate. Hence, small investors gain from it while high income investors have to bear a bigger burden. Investors who are senior citizens and dependent on dividend income have to fulfill their TDS obligations under Form 15G/H. In addition, there is no allowance for collection charges except 20% interest.

7.3. Impact on Domestic Companies and Corporate Policy

The companies now have more cash surplus since the cash flow due to DDT will no longer be there. This enhances the payout ratio – the dividend payout of Nifty 50 was 29% in FY20 and has increased to 36% in FY23. The companies have the flexibility to do capital budgeting without being affected by tax distortion. But there is a new compliance cost that comes along – TDS computation, Form 26Q filing, dealing with various DTAA rates, and getting TRC/PAN from the non-residents.

7.4. Impact on Government Revenue and Tax Administration

Government estimated foregone revenue in case of abolishment of DDT was Rs. 25,000 crores per year, but it was expected to be compensated through TDS at slab rates. As per data provided by CBDT, TDS on dividends has risen from Rs. 12,000 crores in FY 21 to Rs. 28,000 crores in FY 24. However, the administrative cost associated with processing refund for low income stakeholders has risen.

7.5. Removal of Cascading Effect and Introduction of Section 80M

The introduction of section 80M is indeed an encouraging measure to prevent triple taxation of income in holdingsubsidiary systems. However, the condition that allows the deduction of such expenditure only if the dividend is paid one month before the date on which the return of income has to be filed is too stringent and should be relaxed to three months.

VIII. COMPARATIVE PERSPECTIVE

The majority of OECD countries adopt classical or partial imputation system. In USA, taxes on qualified dividends are charged at 15-20% flat rates so that the equity is not discouraged. The UK does not tax dividends till £2000 and charges progressive tax. EU's Parent-Subsidiary Directive exempts from dividends paid intra-EU so that no cascading effect is created. Return to classical system by India is akin to EU's Sustainable Finance Taxonomy system where emphasis is on transparency. However, as opposed to the US system, there is no provision of a flat rate lower than that of capital gain in India. Consequently, there is a distortion favoring buy-back over dividends.

IX. JUDICIAL AND REGULATORY DEVELOPMENTS POST ABOLITION

As per the judgment of the ITAT case of Little Farm Hospitality (P) Ltd. v. CIT, it was seen that if the declaration of the dividends took place before the 31st March 2020 but were paid after this date then such dividends shall be subjected to DDT and not to TDS. CBDT circular no. 19/2020 said that 20% tax is final tax of Section 115A for non-residents.

X. CRITICAL GAPS AND SUGGESTIONS

(i) Apply Flat Rate to Resident Individuals: To escape high 42% liability, dividend income must be taxed at 15% flat rate for residents, as suggested by Kelkar Committee.

(ii) Increase TDS threshold amount: Current limit of Rs. 5000 is too low, increase it to Rs. 50,000.

(iii) Align Taxation of Buy-back and Dividend: Both are profit distribution, hence must have same tax rate.

(iv) Clarify GAAR and PPT Circular: CBDT should issue circular clarifying that any legitimate structure with business purpose will not be subject to GAAR.

(v) Exchange of information between CBDT-SEBI: Comparison of dividend disclosed in Board's Report with TDS return will prevent evasion.

XI. CONCLUSION

The scrapping of Dividend Distribution Tax through Finance Act, 2020 marks a landmark change in direct tax policy of India, signifying the end of a company-based, regressive tax structure in favor of a transparent and share-holder based classical system. For almost two decades, DDT with an effective rate of 20.56% was plagued with certain structural deficiencies - it was regressive since it imposed equal liability irrespective of the income slabs, it did not provide treaty benefits and Foreign Tax Credit to non-residents, and it resulted in cascading impact in holding-subsidiary situations despite some relief provided by Section 115-O(1A). Its scrapping was essential for India to improve its competitiveness and conform to international standards wherein only 8 out of 100 largest economies impose distribution tax on companies. The current study establishes that scrapping of DDT has produced very positive results. It is due to the imposition of dividend tax under Section 56(2)(i) and its withholding under Sections 194 and 195, foreign investors can now enjoy benefit of DTAA rates of 5-15% and can claim FTC in their own countries, which has led to 10% growth in FDI in FY21 amidst coronavirus outbreak. Payout ratio increased from 29% to 36% due to elimination of the tax distorting effect. The return of Section 80M has greatly reduced the issue of cascading. Nevertheless, the reform does have some problems. HNIs are now liable to pay 42.7% rate that is much higher than the previous rate of 20.56%, senior citizens face difficulty in availing TDS refund, Rs.5000 limit puts a burden on companies and MSMEs, and the problem of treaty shopping requires strict implementation of GAAR and PPT rules under MLI. Dividend and buy-back taxation harmonization post-Finance Act, 2024 is still pending. In summary, DDT abolishment has been a progressive step but needs to be supplemented with certain additional steps such as 15% rate for residents, increasing TDS limit to Rs.50,000 and CBDT-SEBI data exchange to make India's dividend tax a model system.

FOOTNOTES

1.Finance Act, 1997, § 6 inserting Chapter XII-D (§§ 115-O to 115-Q) in Income-tax Act, 1961.

2.Income-tax Act, 1961, § 10(34) (exemption of dividend in hands of shareholder under DDT regime, omitted by Finance Act, 2020).

3.Finance Act, 2020, § 12 abolishing DDT w.e.f 1 April 2020.

4.Budget Speech of Finance Minister Nirmala Sitharaman, para 123, Union Budget 2020-21.

5.Income-tax Act, 1961, § 194 (TDS on dividend to residents) as amended by Finance Act, 2020.

6.Income-tax Act, 1961, § 195 read with § 115A (TDS on dividend to non-residents).

7.Income-tax Act, 1961, § 80M (deduction for inter-corporate dividends) reintroduced by Finance Act, 2020.

8.CBDT Circular No. 19/2020 dated 3 July 2020 clarifying TDS rates.

9.Bombay High Court, Small Industries Development Bank of India v. CBDT, W.P. No. 123 of 2025 holding DDT is in substance shareholder's tax.

10.Himanshu Raghuwanshi, Abolition of DDT in India: A Treat for Foreign Investors, 49 Inter tax 1025 (2021).

11.OECD Model Tax Convention, Art. 10 (Dividends) and Commentary on Beneficial Ownership.

12.Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), Art. 7 (Principal Purpose Test), ratified by India in 2019.

13.Income-tax Act, 1961, §§ 95-102 (General Anti-Avoidance Rules).

14.Economic Survey 2019-20, Vol. I, Ch. 4, p. 98 noting DDT impact on payout.

15.SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended in 2021 requiring Dividend Distribution Policy.