II.

Taxing Dividend Income:

A Normative Assessment of the Recent Shift to the Classical System

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This article seeks to explore this issue with reference to the policy considerations that have driven the fluctuations between the two systems of dividend taxation. It first traces the legislative history of dividend income taxation in India, with a deliberate emphasis on the stated objectives and reasoning behind each development. This article thus carries out a contextualised analysis of all four considerations that have been determinative of dividend tax policies in the past, to see how the recent shift actually measures up against the standards it seeks to achieve. This analysis is used to establish that the classical system is better suited to meet the stated objectives than the DDT, but only if pursued alongside stronger investor protection and easier compliance systems.

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In March 2020, the Central Government removed the Dividend Distribution Tax ("**DDT**"), which required companies to pay the tax on their dividend distribution at the rate of 15% (effectively 20.56%).[1] The new model follows the Classical System, which shifts the tax on dividends to recipients, and taxes them as per the rates applicable to their tax brackets. Notably, this switch to the Classical System of taxing the dividend in the hands of recipients is merely another stroke of a pendulum that has been swinging between the two systems since 1961.[2] This compels questions about the existence of any normative consensus on the best way to tax dividends.

This article seeks to explore this issue regarding the policy considerations that have driven the fluctuations between the two systems of dividend taxation. It thus traces the legislative history of dividend income taxation in India, with a deliberate emphasis on the stated objectives and reasonings behind each development. After establishing the relevant considerations, the article attempts to ascertain how each of them is impacted by the shift from DDT to the classical system. Through this analysis, the classical system will be measured against its policy goals, in order to determine both its suitability and its long-term feasibility.

A. Legislative History and Intent

While dividend income taxation has been a topic of discourse across the globe, most economies appear to have stayed within the classical system while making various changes to account for the possibility of double taxation.[3] This has led to questions about whether DDT is a tax on dividend income at all, or if it is an inverse split-rate tax on corporate profits.[4] However, in 2017, when the Indian Supreme Court was asked to examine the constitutional validity

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[1] Dipak Mondal, *Why industry wants dividend distribution tax to be scrapped*, January 31, 2020, https://www.businesstoday.in/union-budget-2020/expectations/why-industry-wants-dividend-distribution-tax-to-be-scrapped/story/394426.html (last visited Aug 23, 2020).
[2] Dividend's tryst with taxation, (2020), https://www.ey.com/en_in/tax/india-tax-insights/dividend-tryst-with-taxation (last visited Aug 10, 2020).
[3] *Id.*
[4] Dhruv Sanghavi, *The Curious Case of the Indian Dividend Distribution Tax – Inverse Split-rates on Corporate Profits? Or a Source-agnostic Levy?*, Kluwer International Tax Blog (2019), http://kluwertaxblog.com/2019/08/22/the-curious-case-of-the-indian-dividend-distribution-tax-inverse-split-rates-on-corporate-profits-or-a-source-agnostic-levy/ (last visited Aug 24, 2020).

of DDT because it was imposed upon agricultural income as well, the Court concluded that dividend being *"declared as distributable among the shareholders, is not impressed with the character of the profits from which it reaches the hands of the shareholder",*[5] leading to the conclusion that dividend is a distinct taxable income from retained profits, and that DDT is indeed a tax on dividend income. In light of this conclusion, the Indian government's oscillation between the classical system and DDT can be understood as a struggle to put in place a dividend taxation method that is suitable for their priorities. The following paragraphs seek to identify what those priorities have been.

When the Income Tax Act was introduced in 1961, dividend income was taxed in the same manner as other incomes- in the hands of the recipients at their usual tax rate. However, by 1997, this method of taxing dividend income had come into controversy, and the Ministry of Finance moved to abolish it. In particular, the Minister of Finance (hereinafter "Finance Minister") cited the need to motivate companies to reduce their dividend distribution and to encourage them to retain and invest their profits with a view towards future growth.[6] Consequently, DDT was introduced at the rate of 10%.

By 2002, DDT had also been the subject ~~of~~ to a substantial amount of debate, and the government concluded that it had done more harm than good. While arguing against DDT, the Finance Minister raised three points.[7] First, that DDT is taxing income in the hands of one to whom it does not belong, and is inherently unfair in the imposition of such burden. Second, mutual funds are understood to have pass-through status, and DDT militates against this. Finally, DDT leads to regressive taxation because high-income recipients are taxed at a much lower rate than the one otherwise applicable to them, and this leads to inequality. The 2002 Finance Act thus abolished DDT, and reinstated the classical system, making two related changes by putting in place a requirement that companies deduct tax at source at 10%, and by allowing companies to claim a deduction for the amount they distribute as dividend to avoid a cascading effect.

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[5] Union of India v. Tata Tea Co. Ltd, (2017) 10 SCC 764.
[6] Union Budget 1997-1998, SERVICE TAX ONLINE, http://www.servicetaxonline.com (last visited Sep 21, 2020).
[7] Union Budget 2002-2003, SERVICE TAX ONLINE, http://www.servicetaxonline.com (last visited Sep 21, 2020).

However, this change was undone the very next year, when the government reintroduced DDT, citing the need to consolidate industrial growth and promote corporate investment.[8] Future governments have suggested that the 2003 shift was also motivated by the need to reduce the compliance burden imposed by the classical system and to make tax collection easier for the state.[9]

In 2014, the effective rate of DDT was increased to approximately 20%,[10] and in 2016, a 10% additional tax was imposed upon resident non-corporate shareholders whose dividend income exceeded Rs 10 Lakhs, to reduce some of the regressive tendencies of the system.[11] Finally, in 2020, the central government decided to abolish DDT, and reintroduce the classical system. The memorandum to the Finance Bill, 2021 cited the same reasons mentioned in 2002, dealing with the unfair incidence and regressive nature of the system. It further mentioned that the ease of collection that drove the 2003 institution of DDT is no longer compelling due to new technology and ease of tracking and that DDT can no longer be justified on that account.[12] In the budget speech,[13] the Finance Minister stated that another significant motivation for her decision was that DDT credit was unavailable for most foreign investors, and this was making India into an unattractive equity investment market. Consequently, several amendments have been made to the Income Tax Act, 1961 (hereinafter "the Act") to ensure a smooth operation of the classical system. Apart from limiting the application of the DDT sub-clauses to March 2020[14] and deleting the provisions excluding dividend income from the total taxable income of persons,[15] Section 80M the Act, providing a deduction for distributed dividend from the dividend income of

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[8] Union Budget 2003-2004, SERVICE TAX ONLINE, http://www.servicetaxonline.com (last visited Sep 21, 2020).
[9] Memorandum | Union Budget of India, https://www.indiabudget.gov.in/memorandum.php (last visited Sep 21, 2020).
[10] Finance (No. 2) Bill, 2014- Memorandum- Provisions Relating to Direct Taxes, https://www.incometaxindia.gov.in/Budgets%20and%20Bills/2014/Memo_2_2014.htm (last visited Sep 22, 2020).
[11] Lubna Kably, *Budget 2016: Dividend pinch for shareholders*, THE TIMES OF INDIA, March 1, 2016, https://timesofindia.indiatimes.com/budget-2016/budget-2016-dividend-pinch-for-shareholders/articleshow/51208736.cms (last visited Jan 15, 2021).
[12] Memorandum | Union Budget of India, *supra* note 10.
[13] Budget Speech | Union Budget, https://www.indiabudget.gov.in/budgetspeech.php (last visited Sep 21, 2020).
[14] Income Tax Act, § 115O, 115R (1961).
[15] *Id*, § 10(34), 10(35), 10(23FC), 10(23FD).

companies, has been reintroduced to avoid the cascading effect.[16] The additional imposition upon non-corporate shareholders who earn over Rs 10 Lakhs via dividend income has been removed,[17] and the requirement to deduct tax at source at predetermined rates has been imposed upon companies.[18]

This discussion suggests that the policies for dividend income taxation in India have primarily been influenced by five factors- impact on dividend distribution, impact on investment, ease of collection, ease of compliance, and equality and fairness concerns. The government has explicitly clarified in 2020 that it no longer considers ease of collection to be a relevant factor due to technological developments, but all remaining four issues remain important to measure the normative value of the current shift.

B. Impact on Dividend Distribution

The government has acted under the assumption that when the dividend tax burden is imposed upon corporations instead of shareholders, the corporations will find dividend distribution more expensive than retention, and this will encourage them to retain and reinvest their profits.[19] They have thus imagined an inverse relationship between DDT and distribution rates. However, data collected under the DDT regime strongly suggest that this is not the case. Two studies, each of which have reviewed dividend policies of hundreds of companies over various years, have found that DDT rates share a significant positive relationship with distribution rates, meaning that companies are distributing more dividend despite it getting more expensive due to higher taxes.[20]

These studies have contributed to global literature that has identified that dividend distribution policies are affected by several seemingly extraneous considerations. It has been theorized that when companies determine how much dividend to distribute, they are motivated by concerns such as their

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[16] *Id*, § 80M.
[17] *Id*, § 115BBDA.
[18] *Id*, § 194.
[19] Sanghavi, *supra* note 5.
[20] Nishant B. Labhane & Jitendra Mahakud, *Determinants of Dividend Policy of Indian Companies: A Panel Data Analysis*, 20 Paradigm 36–55 (2016); Debabrata Datta, Santanu K. Ganguli & Manu Chaturvedi, *Why Do Firms in India Pay Dividend in Presence of Firm Level Dividend Distribution Tax? - An Agency Theory Based Explanation.* (2012), https://papers.ssrn.com/abstract=2189366 (last visited Aug 24, 2020).

growth rates,[21] their years of existence,[22] and their debt-equity ratios,[23] because these factors affect the amount of money that corporations feel the need to retain. The Signalling theory, which has been evidenced by the data found in both the Indian studies, suggests that managers use dividend payments as a tool to deal with informational asymmetry and signal the expected profitability of the company through them.[24]

This literature suggests that dividend distribution decisions are not affected by taxation in any meaningful way. However, studies that have been undertaken within the framework of the Classical System of taxation have found that there may be an indirect impact to be considered. Due to the differential tax rates, investors from different groups are bound to have different priorities. Research has shown that these differences are strong enough to lead to the formation of *tax clienteles,* such that different groups of investors demand different distribution rates from companies.[25] Among these clienteles, large and affluent shareholders have the highest amount of control over dividend policies, because the loss of their investments may pose a threat to the company's financial health and its market valuation.[26]

It is thus clear that dividend taxation does not directly cause companies to affect their distribution structures, but one influence that tax policies do have over distribution is through their impact on the most affluent shareholders. In this light, the shift to the classical system will probably lead to a reduction in distribution rates, and this likelihood is supported by two reasons. First, Indian surveys that have been conducted in contexts with identifiable tax clienteles' evidence that shareholders are motivated to reduce their tax burden, and that large shareholders and promoters hold far more influence

[21] Stewart C. Myers & Nicholas S. Majluf, *Corporate financing and investment decisions when firms have information that investors do not have*, 13 JOURNAL OF FINANCIAL ECONOMICS 187–221 (1984).
[22] DC Mueller, *A life cycle theory of the firm*, 20 (3) JOURNAL OF INDUSTRIAL ECONOMICS 199-219 (1972).
[23] Robert C. Higgins, *The Corporate Dividend-Saving Decision*, 7 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 1527–1541 (1972).
[24] Kose John & Joseph Williams, *Dividends, Dilution, and Taxes: A Signalling Equilibrium*, 40 THE JOURNAL OF FINANCE 1053–1070 (1985).
[25] FRANCISCO PEREZ-GONZALEZ, *Large Shareholders and Dividends: Evidence from U.S. Tax Reforms* (2002), https://papers.ssrn.com/abstract=337640 (last visited Aug 24, 2020).
[26] *Id.*

over dividend distribution rates than smaller retail investors.[27] One survey was conducted after an additional 10% tax was introduced on dividend income exceeding ten lakhs, leading to the creation of two tax clienteles despite the applicability of the DDT. It was found that in 370 of the 500 companies listed on the Bombay Stock Exchange, dividend payout was reduced, and this happened most noticeably in companies with significant inside ownership. This led the authors to conclude that affluent shareholders, and particularly promoters, want to reduce their tax liability, and can significantly affect the distribution decisions of corporate management.[28] A second study was undertaken after the 2002 shift to the classical system, and it was found that a large number of retail investors shifted to companies with higher dividends because their income brackets led to a lower tax rate than the DDT. This leads to the conclusion that where tax rates are low, investors seek to maximize their gains. Despite this, the study found no evidence to suggest that firms altered their dividend pay out to meet the desires of their retail investors.[29] This indicates that with the reinstation of the classical system and the inevitable formation of tax clienteles, affluent investors will want to reduce their tax burdens, and will encourage companies to reduce their dividend distribution.

Second, the changes made, or rather not made, to the Income Tax Act to accommodate the classical system have made it easier for corporate managers to cater to the tax minimisation desire of influential investors while also ensuring that they get their returns for investing in the company. The most prominent example of this is that the Buy-Back Tax (BBT) has not been abolished along with the DDT.[30] Under section 115QA of the Act, unlisted companies, and since 2019 listed companies,[31] are required to pay tax at the rate of 20% on the amount that they provide to investors when they buy back equity.[32] Similar to the DDT, the earnings are exempt in the hands of shareholders to avoid double taxation. It is important to note that the rate of

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[27] Sanjay Dhamija & Ravinder Kumar Arora, *Impact of Dividend Tax Change on the Payout Policy of Indian Companies*, 20 GLOBAL BUSINESS REVIEW 1282–1291 (2019); Shobhit Aggarwal, *Dividend Tax Effects- Evidence from India*, March 9, 2014.
[28] Dhamija and Arora, *supra* note 27.
[29] Aggarwal, *supra* note 28.
[30] Kashif Ali, *Dividend Distribution Tax (DDT)- A complete journey*, 114 TAXMANN.COM (2020).
[31] Mobis Philipose, *Buyback tax: A loophole fixed or an anomaly made worse?* MINT (2019), https://www.livemint.com/opinion/columns/buyback-tax-gap-fixed-or-anomaly-made-worse-1562786500383.html (last visited Oct 18, 2020).
[32] *Supra* note 1, § 115QA.

BBT is significantly lower than the rate at which the affluent shareholders will now be taxed on dividend income. They thus have an incentive to prefer the buyback process over the receipt of dividend. It is suspected that companies will agree with such a request, and will buy back shares to reduce the overall tax burden.[33] Indeed, such a suspicion is only confirmed by the fact that when an additional dividend tax of 10% was introduced for shareholders earning over ten lakhs per annum, companies did respond by increasing buyback activity.[34] It may be argued that due to the 20% tax to be borne by them and the general procedural requirements of organising a buyback, companies may be disincentivised to go ahead with it. However, it must be noted that the overall tax being paid is likely to be lower in buyback transactions. Further, as this paper goes on to argue, even as companies are no longer the target of dividend taxation, their compliance burden has only grown more complicated.[35] Consequently, it appears that the decision between buyback transaction and dividend distribution will be based on a fact-based cost benefit analysis, which will take into account particularities such as transaction costs, shareholder affluency and influence, and growth and leverage considerations. Such uncertainty compels one to consider other alternatives, and mandates a discussion about the possibility of companies using bonus shares instead. While bonus share issues reduce tax liabilities for both companies and investors,[36] such issues are highly regulated in India, are only recommended under certain economic considerations, and do not provide any cash in hand to shareholders.[37] Consequently, it appears that bonus share issues are equally subject to the fact-specific cost-benefit analysis discussed.

Thus, under the classical system, and particularly under the terms of its introduction, dividend distribution rates are likely to reduce. Depending on

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[33] Ali, *supra* note 30.

[34] Share Buybacks on Rise- Business News, https://www.businesstoday.in/magazine/focus/buyback-issues-has-risen-driven-by-psus/story/241211.html (last visited Mar 10, 2021).

[35] *See* the paragraphs under the sub-title 'Ease of Compliance' below.

[36] Staff Writer, *Allotment of bonus shares is not taxable: Karnataka HC*, MINT (2021), https://www.livemint.com/money/personal-finance/allotment-of-bonus-shares-is-not-taxable-high-court-11614946681922.html (last visited Mar 11, 2021).

[37] Bonus Shares: Meaning, Advantages and Disadvantages, LEARN ACCOUNTING: NOTES, PROCEDURES, PROBLEMS AND SOLUTIONS (2016), https://www.accountingnotes.net/shares/bonus-shares-meaning-advantages-and-disadvantages/7398 (last visited Mar 11, 2021); Srinivas Shirur, *Dilemma of Corporate Action: Empirical Evidences of Bonus Issue vs. Stock Split*, 33 VIKALPA 35–48 (2008).

their particular debt and equity concerns, companies may choose to either retain the amount not distributed and reinvest it towards industrial development, to buy back the shares, or to issue bonus shares. However, since a decision to buy back shares is influenced by multiple factors[38] and the issuing of bonus shares allows for the conservation and reinvestment of money,[39] it is likely that the classical system will fulfil the government's goal of increasing corporate retention and reinvestment better than DDT did. At the same time, it is important to consider how this potential fall in distribution rates will impact the valuation of Indian companies, and by extension the Indian equity market, in the minds of investors.

C. Impact on Investment

The government has decided to abolish DDT because it was found to impede increased investment in the Indian equity market. Though the focus of the Ministry of Finance was on foreign investment, this section considers how both domestic and foreign investors are likely to respond to the shift.

i. Domestic Investors

Resident shareholders will perceive the abolishment of DDT as an advantage or disadvantage depending on the rate at which they are taxed. Investors previously bore the burden of DDT at the effective rate of 20.56%.[40] After the implementation of the classical system, they will be taxed based on their income bracket, so investors with brackets under 20% will find the shift beneficial. On the other hand, for investors in the highest income bracket, the tax liability will increase by nearly 28%.[41]

The literature on how investors respond to dividend taxation and policies has led to two important conclusions. First, investors wish to pay the least

[38] Justin Pettit, *Is a share buyback right for your company?* 79 HARVARD BUSINESS REVIEW 141–7, 170 (2001); SARTHAK JENA, CHANDRA SEKHAR MISHRA & PRABINA RAJIB, *Factors Influencing Share Buyback Decisions of Indian Companies* (2016), https://papers.ssrn.com/abstract=2886739 (last visited Oct 18, 2020).
[39] Shirur, *supra* note 37.
[40] Ravindra Agrawal & Pratik Jain, *New Dividend Tax regime in India – Nuances for different types of shareholders and practical challenges!!*, 117 TAXMANN.COM (2020).
[41] Budget Analysis (Series 1) – Removal of Dividend Distribution Tax – BULWARK SOLICITORS, http://www.bulwarksolicitors.com/income-tax/budget-analysis-series-1-removal-of-dividend-distribution-tax/ (last visited Aug 23, 2020).

amount of tax possible.[42] Second, investors prefer companies with higher dividend pay-outs, because they would rather have the cash in hand,[43] and because they are suspicious of corporate management spending retained profits to their own ends.[44]

In cognisance of these conclusions, the likely responses of the two different categories of resident investors can be ascertained. As discussed above, studies suggest that investors who are now faced with higher tax rates are likely to use their influence to reduce dividend pay-outs. Since their interests are prioritised by companies, it is unlikely that they will cease to invest. They may be eager to buy back shares at a premium because of the tax advantage,[45] but even if this happens, it is unlikely that the equity market will be negatively impacted. Buybacks are expected to lead to an increase in share prices in the short term,[46] and high prices are commonly interpreted as a positive signal that encourages investment in the company's stocks.[47] Thus, the overall investment levels will not be reduced.

On the other hand, retail investors whose tax liability has reduced in the new framework are bound to seek increased distribution rates. While data suggests that this demand will not be met, people's investment in the equity market will remain secure due to three reasons. First, as evidenced by the response to the 2002 shift to the classical system, investors are likely to move amongst companies to find a dividend policy that suits their needs instead of exiting the market.[48] Second, the fall in the distribution rate is likely to be set off to some extent by the reduction in the tax liability, negating the overall reduction in dividend amount to some extent. Third, even if retail investors find that dividend distribution rates have fallen, so long as the investment remains objectively profitable and the equity market and company remain

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[42] M. J. Brennan, *Taxes, Market valuation and corporate financial policy*, 23 NATIONAL TAX JOURNAL (1970).
[43] M. J. Gordon, *Dividends, Earnings, and Stock Prices*, 41 THE REVIEW OF ECONOMICS AND STATISTICS 99 (1959).
[44] Rafael La Porta et al., *Agency Problems and Dividend Policies around the World*, 55 THE JOURNAL OF FINANCE 1–33 (2000).
[45] Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases, and the Substitution Hypothesis*, 57 THE JOURNAL OF FINANCE 1649–1684 (2002).
[46] Monika Gupta, *Share Buyback and Announcement Effects: An Industry Wise Analysis*, 6 FIIB BUSINESS REVIEW 43–50 (2017).
[47] P. THIRUMALVALAVAN & K. SUNITHA, *Share Price Behaviour Around Buy Back and Dividend Announcements in India* (2006), https://papers.ssrn.com/abstract=873986 (last visited Oct 18, 2020).
[48] Aggarwal, *supra* note 27.

stable, withdrawing from the market is not considered advisable.[49] Consequently, it is unlikely that domestic investment will be negatively impacted by the introduction of the classical system.

ii. Foreign Investors

The shift to the classical system means that non-resident shareholders will now be able to get credit for their dividend tax liabilities in their home countries,[50] while previously they were unable to do so because the incidence of the DDT did not lie on them. The new system will tax their dividend income at 20%, which suggests a neutral impact in regards to rates. Additionally, India has Double Taxation Avoidance Agreements (DTAAs) with many countries, including the five countries where the largest number of investors in the Indian market reside, [51] and these agreements have beneficial rates that will reduce the investor's tax liability even further. [52] Thus, it appears that for foreign investors, the implementation of the classical system is going to lead to a reduction in tax liability as well as a reduction in dividend amounts, which is similar to the situation of domestic investors with lower tax brackets.

However, it has been theorised that for international investors, decisions are not quite as straightforward because domestic regulation, or their assessment thereof, affects responses to changes in dividend distribution. The priorities and responses of foreign investors are motivated by the level of investor protection they anticipate in each country.[53] Where investors are well protected, they are relatively unbothered by lower dividends, because they

[49] Matthew Frankel CFP, *When to Sell Stocks*, THE MOTLEY FOOL (2018), https://www.fool.com/investing/how-to-invest/stocks/when-to-sell-stocks/ (last visited Oct 18, 2020); Full Bio Follow Linkedin Follow Twitter Ken Little is the author of 15 books on the stock market, investing He is a former stocks & investing writer for The Balance Read The Balance's editorial policies Ken Little, *When Should I Sell My Stock?*, THE BALANCE , https://www.thebalance.com/when-is-right-time-to-sell-a-stock-3140959 (last visited Oct 18, 2020); Lisa Smith, *Is Your Money Safer in the Market or Held as Cash?*, INVESTOPEDIA , https://www.investopedia.com/articles/basics/09/cash-is-king.asp (last visited Oct 18, 2020).
[50] Pedro Gonçalves, *Non-resident investors to benefit from India's abolition of dividend distribution tax*, INTERNATIONAL INVESTMENT (2020), https://www.internationalinvestment.net/news/4010032/resident-investors-benefit-india-abolition-dividend-distribution-tax (last visited Aug 23, 2020).
[51] Niranjan Govindekar, Deepa Seth & Devdutt Thakkar, *Abolition of DDT- You win some, you lose some!!*, 114 TAXMANN.COM (2020).
[52] Gonçalves, *supra* note 50.
[53] Mohammed Alzahrani & Meziane Lasfer, *Investor protection, taxation, and dividends*, 18 JOURNAL OF CORPORATE FINANCE 745–762 (2012).

have reason to believe that the laws will protect them against malpractices by managers, and are thus comfortable with profits being retained by companies. On the other hand, in countries with weak investor protection, the anxieties of the agency theory are far more palpable and investors seek higher dividends irrespective of what the tax costs may be.[54] Sources suggest that India has poor, or at the very least unpredictable, investor protection,[55] and recent events have painted the country as unfriendly to foreign investors.[56] In this scenario, international investors are likely to be dissuaded from investing by reductions in distribution rates. Thus, the classical system's introduction may have the counterintuitive consequence of discouraging foreign investment if it causes a noticeable decrease in dividend distribution. The goal of increasing such investment will remain unfulfilled until the faith of investors in Indian regulations and implementation frameworks is improved.

D. Ease of Compliance

Aside from the rate of taxation, it is also crucial to note that the *incidence* of DDT fell on companies. Even if it did not lead to an increased financial burden because the effects could be transferred over to shareholders, the compliance burden stayed with corporations. With the incidence being shifted over to shareholders, it would be reasonable to assume that the compliance burden will also be transferred. However, commentary about the recent abolition of DDT has strongly suggested that the compliance burden on both corporations and some categories of investors is more complicated under the classical model.[57]

Companies will now be required to deduct tax (TDS) at 10% for payments over Rs 5000 to resident shareholders, and at 20% for all non-resident shareholders.[58] This means that they will be required to keep records of all

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[54] *Id.*
[55] J. Mulraj, *No investor protection in India*, @BUSINESSLINE, https://www.thehindubusinessline.com/markets/no-investor-protection-in-india/article30360091.ece (last visited Oct 18, 2020).
[56] Ritesh Kumar Singh, *India must end tax terror spooking foreign investors*, NIKKEI ASIA (2020), https://asia.nikkei.com/Opinion/India-must-end-tax-terror-spooking-foreign-investors (last visited Oct 18, 2020).
[57] Sankalp Malik & AA Jain, *Abolition of DDT Vide Finance Act, 2020 and Its Impact*, 117 TAXMANN.COM (2020); Agrawal and Jain, *supra* note 40; Subham Kumar & Bhavesh Kumar, *Taxability of dividends in the hands of shareholders – A half-baked solution?,* 114 TAXMANN.COM (2020).
[58] *Supra* note 14, §115A.

their investors that identify both categories clearly, and to deduct and deposit the correct amount of TDS, file timely TDS returns, and issue the related certificates to shareholders.[59] Further, resident shareholders will need to be differentiated on two different lines. First, shareholders with dividend income under Rs 5000 will need to be excluded from the ambit of this process. Second, for shareholders who have not provided their PAN cards or whose KYC information is inaccurate, companies will be required to deduct TDS at a higher rate than 10%, following the provisions of Section 206AA.[60] For non-resident shareholders, companies may deduct TDS at a lower rate where the beneficial provisions of a DTAA are applicable. To do so, they will need to collect extensive documentation from the shareholders, and the deduction rates will end up varying from investor to investor due to them belonging to different countries.[61] This complexity in compliance is likely to encourage companies to seek out mechanisms of reducing the burden. This may thus contribute another reason for companies to reduce distribution amounts, or to prefer buying shares back instead of making dividend pay-outs at all. However, the reduction in dividend distribution will not necessarily mean increased reinvestment, which is the end concern. A report drafted based on a World Bank study about tax developments in 183 countries concluded that the more time and resources businesses are forced to spend on tax compliance, the lesser time and resources can be invested in their projects, and this negatively impacts potential economic growth.[62] Thus, the complicated compliance procedure under the classical system, as implemented, may incentivize companies to reduce distribution but its associated cost may hold back any potential increase in industrial investment and growth.

The TDS provisions also increase the compliance burden on non-resident investors who seek to rely on the beneficial rates in DTAAs. Section 115A provides that foreign investors will not need to file tax returns in India if their total income is limited to dividend income and the withholding rate is higher than or equivalent to 20%.[63] Thus, if the corporations deduct TDS at the beneficial rate applicable, the shareholder will have to file tax returns. On the other hand, if the company withholds tax at the statutorily determined rate without reference to DTAA provisions, then shareholders will be compelled to

[59] Agrawal and Jain, *supra* note 40.
[60] *Supra* note 14, § 206AA.
[61] Agrawal and Jain, *supra* note 40.
[62] PAYING TAXES. THE COMPLIANCE BURDEN, 44 (2011).
[63] *Supra* note 14, § 115A.

file returns to benefit from lower rates and have the excess tax amount reimbursed. It has been argued that for many retail foreign investors, the dividend income will not be significant enough to make this process practical, and such investor may then find the Indian investment market less than ideal.[64] If the dividend amount plays a role in investors arriving at this finding, and the classical system simultaneously leads to reductions in dividend amount, then this perception of the equity market will be doubly reinforced.

Aside from its impact on dividend distribution and investment, ease of compliance is an important consideration because it has a direct and well-established connection with ease of collection for tax authorities. When tax administration systems are effective and convenient for payers, voluntary compliance increases, and lesser errors are made.[65] Ease of collection has been a major consideration for the government in the past, and while the Finance Minister has expressed her belief that new technology will make collection from shareholders easier, the impact of convoluted compliance requirements is a distinct point that may merit consideration. Indeed, the significant consequences of difficult compliance have been recognised across the world,[66] and have led to the creation of international organisations such as the OECD's Forum on Tax Administration.[67]

E. Fairness of Differential Burdens

All investors will not face a uniform impact under the classical model. Two distinct lines of differentiation appear to exist. First, investors will now be taxed based on their income brackets instead of a uniform tax being levied on all dividend payments, which means that some investors will be forced to pay higher taxes than others. It has been argued that the highest effective tax rate is now being imposed upon the risk-taking and wealth-creating investors.[68] On the other hand, it has also been submitted that this disparate impact is fair because the classical system allows for the rationale of

[64] Agrawal and Jain, *supra* note 40.
[65] Bernardin Akitoby, *Improving Tax Collection, Raising Tax Revenue and Lessons in Tax Reform*, 55 Finance & Developement (2018), https://www.imf.org/external/pubs/ft/fandd/2018/03/akitoby.htm (last visited Oct 18, 2020).
[66] Paying Taxes. The compliance burden, *supra* note 62.
[67] About - Forum on Tax Administration, http://www.oecd.org/tax/forum-on-tax-administration/about/ (last visited Oct 18, 2020).
[68] Dividend's tryst with taxation, *supra* note 2.

progressive taxation to be applied for dividends.[69] In light of these differing conclusions, it becomes important to consider how equality should be understood for differential tax burdens.

The Supreme Court of India has had multiple occasions to examine tax laws within the framework of Article 14 of the Constitution and the equality it promises. In 1991, the Court examined what 'equal protection of laws' means for taxation, and held that the Article could not have "*intended to compel the State to adopt an iron rule of equal taxation*".[70] Instead, the rule of equality requires that the same means be applied to members of the *same class,* such that the law operates equally and uniformly amongst people in similar circumstances.[71] Thus, the Indian Constitution has envisioned equality to mean equal treatment of equals, and not of unequals.[72]

Indeed, equal treatment of people placed unequally may amount to indirect discrimination when it leads to one group facing a disparate impact as a consequence of seemingly neutral provisions.[73] Such indirect discrimination has been recognised as a violation of Article 14 by the Supreme Court.[74] The Court has discussed this in the context of tax law and has held that where persons who are essentially dissimilar are taxed uniformly, it may amount of discrimination and "*refusal to make a rational classification may itself in some cases operate as denial of equality*".[75]

Thus, progressive taxation which seeks to impose different tax burdens based on the income levels of investors is not only permissible but to do otherwise may be equitable. The Supreme Court has discussed the permissibility of progressive taxation on multiple occasions,[76] and as early as 1958, the Calcutta High Court affirmed its constitutionality, and found it to be "*a*

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[69] Kavit Vijay, *All about Dividend Income and Dividend Distribution Tax i.e DDT*, VJM & ASSOCIATES (25 May2020), https://vjmglobal.com/blog/income-tax/dividend-distribution-tax-and-dividend-income/ (last visited Aug 25, 2020).
[70] Spences Hotel (P) Ltd. v. State of W.B., (1991) 2 SCC 154.
[71] *Id.*
[72] K.T. Moopil Nair v. State of Kerala, (1961) 3 SCR 77.
[73] Sandra Fredman, *Substantive equality revisited*, 14 INT J CONST LAW 712–738 (2016).
[74] Gautam Bhatia, *Navtej Johar v Union of India: Rethinking Rajbala, and the Way Forward*, INDIAN CONSTITUTIONAL LAW AND PHILOSOPHY (2018), https://indconlawphil.wordpress.com/2018/09/15/navtej-johar-v-union-of-india-rethinking-rajbala-and-the-way-forward/ (last visited Oct 18, 2020).
[75] State of Kerala v. Haji K. Haji Kutty Naha, AIR 1969 SC 378.
[76] Jindal Stainless Ltd v. State of Haryana, (2017) 12 SCC 1.

practical and reasonable system of classification".[77] The Court also went on to say that a flat rate applicable across groups would be the "*most inequitable arrangement*".[78]

In this framework, it seems clear that the classical system is to be preferred over the DDT, which forced people from different income groups to bear the same amount of tax irrespective of how it impacted them. One may argue that when the classical system is applied, the investors affected are the ones who generate the most wealth, and unequal impact may dissuade them from investing. However, it is well established that the taxation law requires the state to balance various social and economic interests and values, and the state has the power to decide "*what economic and social policy it should pursue and what discriminations advance those social and economic policies*".[79] The classical system is oriented towards social equality and wealth redistribution,[80] and the state is entitled to prioritise these goals.

The second line of differentiation is that resident and non-resident inventors are not being treated equally. Given that at least some domestic investors will be forced to pay higher taxes, while foreign investors will never be asked to pay more than 20%, it has been argued that the new model has created an uneven playing field that is discriminatory and discouraging for Indian investors.[81]

However, it is a settled position today that the state has wide latitude when it comes to determining classifications of persons for taxation purposes.[82] Non-resident investors are being taxed at a fixed rate which is lesser than the rates for some tax brackets, and are even being allowed to benefit from lower rates if found eligible under DTAAs because the state is pursuing its stated objective of incentivising foreign investment into the Indian equity market. Increased inflow of foreign investment is expected to have a positive impact

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[77] Seth Sukhlall Chandanmull v AC Jain*,* 1959 SCC OnLine Cal 161.
[78] *Id.*
[79] P.M. Ashwathanarayana Setty v. State of Karnataka, (1989) Supp. (1) SCC 696.
[80] Shamika Ravi, *Progressive taxation will help bring down income inequality*, MINT (2019), https://www.livemint.com/politics/policy/progressive-taxation-will-help-bring-down-income-inequality-1563304144418.html (last visited Oct 18, 2020).
[81] Budget Analysis (Series 1) – Removal of Dividend Distribution Tax – BULWARK SOLICITORS, *supra* note 41.
[82] Elel Hotels and Investments Ltd. v. Union of India, (1989) 3 SCC 698.

on the country's economic welfare,[83] and there is no competing interest of social welfare with regards to non-resident investors. Consequently, even if the resident and non-resident investors are being treated differently, the state is entitled to do so in light of the economic ends it is pursuing.

F. Conclusion

The question of how well the classical system responds to the major considerations behind dividend policy is seemingly met with an array of responses. The classical system meets concerns of welfare and equity far better than the DDT, and also has the potential of encouraging profit retention better. On the other hand, lower distribution rates may undermine the policy of encouraging foreign equity investment. Further, the complicated compliance requirements may restrict the reinvestment of retained income by companies and discourage non-resident investors.

However, when the actual causes behind the problems are considered, a clearer picture emerges. Foreign investment will not be held down if the perception of India is changed to be more investor-friendly. The improvement of investor protection is a distinct goal that is being pursued simultaneously, and World Bank data suggests that this pursuit has been successful.[84] Similarly, difficult tax administration and compliance are caused not by the classical system itself, but by the way in which it has been implemented. The necessity of simplifying tax compliance has been recognised by the state and is being pursued via both technological innovation[85] and modifications in the law.[86] The shift to the classical system is then best understood as a part of broader tax reforms, with interconnections between the different limbs. Seen in this light, the classical system being put into place in 2020 is better suited to meet all four policy considerations in comparison to DDT. If pursued in

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[83] Ana Balcão Reis, *On the welfare effects of foreign investment*, 54 Journal of International Economics 411–427 (2001).

[84] Open Trade and Competitiveness Data: India, The World Bank, https://tcdata360.worldbank.org/countries/IND?indicator=648&viz=line_chart&years=2007,2017&country=IND (last visited Oct 18, 2020).

[85] Sindhu Hariharan, *Income Tax Filing: As tech simplifies tax compliance, CAs worry*, The Times of India, July 10, 2019, https://timesofindia.indiatimes.com/business/india-business/as-tech-simplifies-tax-compliance-cas-worry/articleshow/70149899.cms (last visited Oct 18, 2020).

[86] Sumita Kale, *Taxing times: Compliance complexity a big challenge for businesses*, The Financial Express (2019), https://www.financialexpress.com/opinion/explained-here-is-how-tax-compliance-complexity-is-the-challenge/1682478/ (last visited Oct 18, 2020).

consonance with stronger investor protection and efficient compliance systems, this shift has the potential to be both beneficial and sustainable.