**DIVIDEND POLICY**

Under section 2(22), the following payments or distributions by a company to its shareholders are deemed as dividend to the extent of accumulated profits of the company:

1. any distribution entailing the release of company’s assets
2. any distribution of debenture, debenture stock, deposit certificates and bonus to preference shareholders
3. distribution on liquidation of company
4. distribution on reduction of capital
5. any payment by way of loan or advance by a closely held company to a shareholder holding substantial interest provided the loan should not have been made in the ordinary course of business and money lending should not be substantial part of the company’s business.

The following shall not be treated as dividend

1. any payment made by a company on purchases of its own shares
2. any distribution of shares made in accordance with the scheme of 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

Payment by way of loan/advance to the extent of accumulated profits (excluding capitalised profits) by a closely held company is treated as dividend in the following two cases U/S 2(22)(e):

|  |  |
| --- | --- |
| Case I | Case 2 |
| Loan or advance is given by closely held companies | Loan or advance is given by closely held companies (say X ltd.) |
| Such loan is given to a registered shareholder | Such loan is given to a ‘Concern’ (say Y it may be HUF, AOP, Firm etc.) |
| The shareholder (getting loan) beneficially holds 10% or more of equity shares in the company (giving loan) | One of the shareholders, beneficially holding 10% equity share capital in X ltd. has a substantial interest (20% right) in Y |
| Such loan or advance is treated as dividend in the hands of shareholder | Such loan or advance is treated as dividend in the hands of Y |

If bonus shares are issued to equity shareholders, it does not amount to distribution of dividend at the time of issue of bonus shares, as there is no release of assets. But if bonus shares are redeemed ( if preference shares are issued as bonus shares), there will be release of assets and in that event these would constitute dividend.

Rate of dividend tax : From April 2018 (being deemed dividend under section 2(22)(e)

Dividend Tax = 30% of dividend

Surcharge = 12% of Dividend Tax

HEC = 4% of dividend tax and surcharge

Total = 34.944%

Relief in case of inter-corporate dividend in some cases 115-O(1A)

Dividend declared, distributed or paid by the holding company -------

to its shareholders

Less: Dividend received from subsidiary domestic company --------

Balance on which dividend tax is payable by the holding company --------

Deduction of Tax at source from dividend Sec.194

w.e.f. 1/4/2018 TDS on dividend under section 194 is not applicable.

**Hints for tax planning**

1. In order to avoid to tax liability on deemed dividend under section 2(22)(e) the following planning may be adopted:
2. Trade advances may be given because trade advances ( which are in nature of commercial transactions) are not covered under section 2(22)( e) examples:
	1. Advances were made by a company to a sister concern and adjusted against the dues of job work done by the sister concern
	2. Advance was 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 company could fulfil an export order
	3. A floating deposit security was given by a company to its sister concern against the use of electricity generation belonging to sister concern. The company utilised gas available to it from GAIL to generate electricity and supplied it to the sister concern at concessional rates.
3. If relationship between company and its shareholder is as a debtor or creditor then up to available existing balance as debtor or creditor shall not be treated as dividend. any amount in excess to existing balance shall be treated as advance and comes under the definition of section 2(22)(e).
4. Section 2(22)(e) is applicable even if loan is repaid before the end of the previous year.
5. Even loan obtained by the assessee- shareholder from a company from out of its accumulated profits, which are exempt in the hands of the company as agriculture income. is to be treated as deemed dividend in the hands of the assessee.
6. Advance received by a shareholder from a closely held company allegedly against slae of property, possession of which is to be handed over after more than 5 years, will be treated as ‘deemed dividend’ under section 2(22) (e).

Example: Determine Accumulated profit for the purpose of section 2(22) for XYZ ltd. from the following information and comment upon it:

|  |  |  |  |
| --- | --- | --- | --- |
| Liabilities | Amount | Assets  | Amount |
| Preference share capitalEquity share capitalIssued against CashIssued as bonus sharesGeneral ReserveInvestment allowance reserveDepreciation reserveProfit and loss a/c 1/4/2017 2,40,000Add profit 17-18 60,000Provision for taxation and dividend Current liabilities | 4,00,0006,00,0006,00,0003,00,00090,0001,00,0003,00,0002,30,0002,00,000 | Fixed Assets (before dep)Investment in share (market value ₹13,00,000)Other Assets | 15,00,0004,00,0009,20,000 |

Note: Profit and loss account balance on April 1, 2018 includes agriculture income of ₹30,000

**Solution**:

As under the provision of section 2(22), a payment/distributed is treated as dividend only to the extent of accumulated profits, one has to first ascertain ‘accumulated profits’ to apply the deeming fiction of section 2(22). Accumulated profit, as on March31,2018 is calculated as under:

Particulars for sub-clauses a,b,c,d for sub clause e

Capitalised profit (bonus shares) 6,00,000 nil

General Reserve 3,00,000 3,00,000

Investment Allowance Reserve 90,000 90,000

Depreciation Reserve nil nil

Balance of Profit and Loss account 2,40,000 2,40,000

(agricultural income even if tax free, forms part)

current profit 60,000 60,000

Provision for taxation nil nil

( it is considered if it is reserve)

Total 12,90,000 6,90,000

Comment:

1. if the company declares as pays dividend say of ₹10,00,000 on 1/4/2018 in cash, the entire amount would be treated as dividend as it does not exceed ₹12,90,000 and company would have to pay dividend tax.
2. if the company issues bonus shares of ₹3,00,000 by capitalising general reserve to its equity shareholders, it is not treated as dividend and hence not chargeable to dividend distribution tax.
3. if the company issues redeemable preference shares on 1/4/2018 of ₹3,00,000 to its equity shareholders as bonus shares by capitalising general reserves, it will not amount to dividend.
4. If the company issues bonus shares to preference shareholders on 5/4/2018, it amounts to dividend ( to the extent of accumulated profit) and is chargeable in the hands of company to dividend tax.(section 2(22) (b).
5. If company reduces its share capital and pays ₹8,00,000 on 1/5/2018 to its shareholders, it will amount to dividend under section 2(22)(d) as it does not exceed ₹12,90,000
6. Suppose XYZ ltd gives a bona fide loan of ₹8,00,000 to X who holds 15% share capital)on 10/4/2018 for 1.5 months @ of 11% p.a., it will amount to dividend under section 2(22)(e) to the extent of accumulated profits (6,90,000) in the hands of X even if:
	1. X repay loan with interest within 1.5 months or
	2. X holds just 15% share and the company claims that his proportionate share in the accumulated profit is ₹103500 (15% of 6,90,000)

Up to 31/3/2018 deemed dividend under section 2(22)(e) is taxable in the hands of the recipients of loan or advances (dividend tax under section 115-O is not applicable). However this provision has been amended with effect from 1/4/2018, after the amendment, deemed dividend will be exempt in the hands of recipient by virtue of section 10(34). Dividend tax is payable under section 115-O by the company giving loan or advance. in this case nothing is taxable in the hands of X. XYZ ltd will pay tax as follows:

Accumulated profits 6,90,000

Less: Dividend tax under section 115-O (6,90,000\*34.944/134.944)1,78,677

(tax 30%, Surcharge12% HEC4%)

Accumulated profits 5,11,323

Deemed dividend out of ₹8,00,000 5,11,323

Dividend tax liability of XYZ ltd. 34.944% of ₹5,11,323 1,78,677

**Example:**

**Bonus Shares**

Tax consideration is given below

1. Bonus shares to equity shareholders:

|  |  |  |
| --- | --- | --- |
| Situation | Tax Treatment in the hands of company issuing bonus shares | Tax treatment in the hands of shareholders |
| At the time of bonus shares | No Tax Liability | No Tax Liability |
| At the time of sale of bonus shares | No Tax Liability | Bonus shares acquired before 1/4/2001: FMV on 1/4/2001 is taken as cost of acquisitionBonus shares acquired after1/4/2001: Cost of acquisition Nil |
| At the time of redemption of bonus shares or at the time of liquidation of the company | Under section 2(22)(a) or 2(22)(c), it will be treated as dividend distribution to the extent of accumulated profits and consequently, the payer company will pay dividend distribution tax. | Out of the amount received at the time of redemption or liquidation, amount treated as dividend under section 2(22)(a) will be exempt in the hands of shareholders, balance will be sale consideration to compute capital gain |

1. Bonus shares to preference shareholders: Rarely bonus shares are issued to preference shareholders. Tax treatment is given below:

|  |  |  |
| --- | --- | --- |
| Situation | Tax Treatment in the hands of company issuing bonus shares | Tax treatment in the hands of shareholders |
| At the time of bonus shares | Under section 2(22)(b) it will be deemed as dividend and chargeable to dividend tax | No Tax Liability |
| At the time of sale of bonus shares | No Tax Liability | Bonus shares acquired before 1/4/2001: FMV on 1/4/2001 is taken as cost of acquisitionBonus shares acquired after1/4/2001: Cost of acquisition Nil |
| At the time of redemption of bonus shares or at the time of liquidation of the company | No Tax Liability | No Tax Liability |

Tax Planning:

1. When a company issues bonus shares to its equity shareholders, it is not a deemed dividend and the company is not liable to pay tax on such deemed dividend. Hence, a domestic company may issue bonus shares to its equity shareholders instead of dividend in cash to reduce its tax liability.
2. A preference shareholder may first convert preference shares into equity shares and thereafter receives bonus shares. This will reduce the tax liability at least at the time of issue of bonus shares.
3. A company may capitalise its profit by converting partly paid up shares into fully paid shares instead of issue of bonus shares. This conversion will not be deemed dividend.
4. Where bonus shares are received by a firm it may transfer such shares to partners by sale. When such shares are transferred by sale, the buyer will get the benefit of indexation of cost.
5. The company should issue equity shares as bonus shares. If the shareholder sells these shares after holding for one year and pays securities transaction tax, the LTCG will be exempt U/S 10(38). If sells these shares as short term capital asset and pays STT, the STCG will be liable to tax @15%+surcharge if any + Cesss.