Issue 1 – Dividend Vs. Buyback – Tool for a Tax Planning

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Dividend, Dividend Distribution Tax, & Buyback – Restructuring Scheme

Indian shareholders have been fancied of dividend paying stocks. Often, regular dividend paying stocks are valued using Gordon's growth model and usually fall in frequently traded stocks. Two Stakeholders of the dividend are one the company declaring and paying dividend and second the recipient (corporate or non-corporate). For CEOs and CFOs, it becomes imperative to understand blended accounting-tax treatment in the process of dividend declaration. Under Income Tax act, dividends are governed by section 115 O. Historically, the recipient of the dividend was free from tax encumbrances as the company declaring dividend has paid taxes on such distribution. However, post 31st March 2020, the DDT is abolished, and tax burden is shifted to recipient of the dividend income per respective tax bracket. First we will understand position until 31st March 2020 and then post 31st March 2020 i.e. post abolishment of DDT. Finally, we will discuss restructuring through buy-back that offers substantial tax leverage to higher income tax bracket shareholders.

DDT & Ind AS Implications until 31st March 2020

Domestic companies were required to pay dividend distribution tax (DDT) for income (Current or Accumulated) distributed at 15%. If recipient Parent further distributes the income out of dividend received from the subsidiary, DDT is applicable on dividend distributed net of dividend received from a domestic subsidiary.

If company wants to pay a dividend of Rs. 102 net of DDT, the total dividend (inclusive of DDT) accumulates to Rs. 120 as follows:

Particulars	**Rs.**
Dividend to be paid in cash net of DDT	102
Dividend Distribution Tax (ignoring cess)	15%
Hence, gross dividend	102 / (100%-15%) = 120

Dividend distributed is a reduction in Equity and presented accordingly in the statement of changes in equity. Many accounting professionals, nevertheless, bewilder with accounting for taxes on such dividends. We will simplify an accounting for DDT in the books of subsidiary and its parent through following example.

Small Ltd. is a wholly owned subsidiary of Peace Ltd. During the year, Small Ltd. paid dividend amounting to Rs. 50 lakhs to Peace Ltd and paid Dividend Distribution Tax (DDT) of Rs. 8.83 lakhs to the taxation authorities (i.e. Rs. 8.83 lakhs of dividend (representing 15%) on total dividend of Rs.58.83 lakhs).

Common questions to CEOs & CFOs are listed below.

1. What would be the accounting treatment and presentation in the separate financial statements of Small Ltd. and Peace Ltd?

2. What would be the accounting treatment and presentation in the consolidated financial statements of Peace Ltd?
3. Suppose Peace Ltd further distributed dividend of Rs. 70 lakhs to its shareholders and the DDT liability on such dividend amounts to Rs. 12.35 lakhs. As per taxation laws, DDT of Rs. 8.83 lakhs paid by Small Ltd. is available for set off against DDT payable by Peace Ltd. Thus, Peace Ltd paid Rs 3.52 lakh (12.35 lakhs – 8.83 lakhs) to the taxation authorities.
   What would be the accounting treatment for the above transaction?

Accounting entries in individual financial statements of Subsidiary (Amounts in lakhs)

In the books of Small Ltd.

a)	Retained earnings A/C…. Dr	58.83
	To Dividend liability	50
	To DDT payable	8.83

(Being liability for dividend created out of entity's reserves)

b)	Dividend liability… Dr	50
	DDT payable… Dr	8.83
	To Bank	58.83

(Being dividend paid)

Presentation of Dividend

Para 35 and 36 of Ind AS 32 Financial Instruments: Presentation state that the classification of the financial instrument as a financial liability or equity will determine the presentation of any distribution made in relation to it. Such distribution may be in the form of interest, dividend, losses or gains. Thus, if a financial instrument is classified as financial liability, interest paid thereon is in the nature of interest expense which is recognised in the statement of profit or loss. Whereas if such instrument is classified as equity, dividend distributed on the same shall be recognised as change in equity i.e. part of statement of changes in equity.

Presentation of DDT

Para 57A of Ind AS 12 provides that the income tax consequences are linked more directly to the past transactions or events that generated the distributable profits. An entity shall recognise the income tax consequences arising out of distribution to owners in Profit or loss, OCI or Equity, according to where the entity originally recognised the past transactions or events.

Para 65A of Ind AS 12 indicates that DDT payable under the taxation laws in India is a form of withholding tax. Had there been no DDT mechanism, dividend distributed by the entity would have been taxable in the hands of the shareholders. Thus, DDT is basically the portion of tax paid by the entity to the taxation authorities, on behalf of its shareholders

As per Para 61A of Ind AS 12, current and deferred tax that relates to items that are recognised directly in equity, shall be recognised directly in equity.

Presentation of DDT paid on the dividends should be consistent with the presentation of the transaction that creates those income tax consequences. In a given case, DDT should be recognised in equity, since dividend distribution to equity shareholder Peace Ltd is recognised in equity.

Accounting entries in separate financial statements of Parent (Amounts in lakhs)

In the books of P Ltd (Separate Books of Accounts)

a)	Retained earnings A/C…. Dr	73.52
	To Dividend liability	70
	To DDT payable	3.52

(Being liability for dividend created out of entity's reserves)

b)	Dividend liability… Dr	70
	DDT payable… Dr	3.52
	To Bank	73.52

(Being dividend paid)

Accounting entries in consolidated financial statements of Parent (Amounts in lakhs)

In the consolidated P/L of Peace Ltd

DDT expense A/C…. Dr	8.83
To Bank	8.83

(Being DDT paid by subsidiary)

Dividend paid by Small Ltd. and dividend income received by Peace Ltd would get eliminated as part of intra group transactions. Only DDT paid to income tax authorities will be shown as an expense in consolidated statement of Profit and Loss of Peace Ltd.

Accounting treatment when set off for DDT paid by subsidiary is available

In such case, total amount of DDT paid (8.83 lakhs paid by Small Ltd. and 3.52 lakh paid by Peace Ltd) at a consolidated level will be recognised in the consolidated statement of changes in equity of Peace Ltd. Due to Peace Ltd.'s transaction of distributing dividend to its shareholders (transaction recorded in Peace Ltd.'s equity) and the related DDT set-off, this DDT paid by the subsidiary is effectively a tax on distribution of dividend to the shareholders of the parent company.

Dividend & Ind AS post abolishment of DDT from 1st April 2020

After DDT is abolished, dividend income in the hands of shareholder is taxable per the tax bracket of the shareholder. This means, tax payers who are paying taxes up to 20% tax bracket would get benefitted with new scheme. Similarly, foreign investors who were not getting benefit of DDT in India for their respective domestic taxation will now get benefit of income taxes paid in India on such dividend income through double taxation avoidance agreements. However, abolishment of DDT also means higher income tax bracket tax payer would now pay taxes at 30% plus cess instead of 15 plus cess. At a policy level, Indian government has analysed overall positive impact of elimination of DDT facilitating incremental in foreign investments.

Consequently, accounting entries in the books of subsidiary and parent companies are as follows.

Accounting entries in individual financial statements of Subsidiary (Amounts in lakhs)

In the books of Small Ltd.

a)	Retained earnings A/C…. Dr	50
	To Dividend liability	50

(Being liability for dividend created out of entity's reserves)

b)	Dividend liability… Dr	50
	To Bank	50

(Being dividend paid)

Accounting entries in separate financial statements of Parent (Amounts in lakhs)

In the books of P Ltd (Separate Books of Accounts)

a)	Retained earnings A/C…. Dr	70
	To Dividend liability	70

(Being liability for dividend created out of entity's reserves)

b)	Dividend liability… Dr	70
	To Bank	70

(Being dividend paid)

Restructuring through Buyback for Higher income tax bracket tax payers

In order to avoid higher tax costs to higher income tax bracket tax payers, consultants can device a buy-back scheme under Companies Act, 2013 and achieve substantial cost benefit of approximately 7.9% of gross dividend amount. Let me explain how a dividend income of say Rs. 7.52 crore with a particular capital structure of historically profit making company can be restructured through buyback as below.

Assessment of Dividend Income & Tax thereon

Case I – Taxpayers are falling under higher income tax bracket but not liable to pay surcharge

Name of equity shareholder	No. of equity shares held	Dividend entitlement	Maximum rate of tax (without surcharge)	Income tax on dividend income *	Net distribution to shareholder
Shareholder 1	5,000	1,50,40,000	31.20%	46,92,480	1,03,47,520
Shareholder 2	3,000	90,24,000	31.20%	28,15,488	62,08,512
Shareholder 3	2,500	75,20,000	31.20%	23,46,240	51,73,760
Shareholder 4	4,000	1,20,32,000	31.20%	37,53,984	82,78,016
Shareholder 5	3,000	90,24,000	31.20%	28,15,488	62,08,512
Shareholder 6	4,500	1,35,36,000	31.20%	42,23,232	93,12,768
Shareholder 7	3,000	90,24,002	31.20%	28,15,489	62,08,513
	25,000	**7,52,00,002**		**2,34,62,401**	**5,17,37,601**

Case II - Taxpayers are falling under higher income tax bracket & liable to pay surcharge at 10%

Name of equity shareholder	No. of equity shares held	Dividend entitlement	Maximum rate of tax (with 10% surcharge)	Income tax on dividend income *	Net distribution to shareholder
Shareholder 1	5,000	1,50,40,000	34.32%	51,61,728	98,78,272
Shareholder 2	3,000	90,24,000	34.32%	30,97,037	59,26,963
Shareholder 3	2,500	75,20,000	34.32%	25,80,864	49,39,136
Shareholder 4	4,000	1,20,32,000	34.32%	41,29,382	79,02,618
Shareholder 5	3,000	90,24,000	34.32%	30,97,037	59,26,963
Shareholder 6	4,500	1,35,36,000	34.32%	46,45,555	88,90,445
Shareholder 7	3,000	90,24,002	34.32%	30,97,037	59,26,965
	25,000	**7,52,00,002**		**2,58,08,640**	**4,93,91,362**

Case III - Taxpayers are falling under higher income tax bracket & liable to pay surcharge at 15%

Name of equity shareholder	No. of equity shares held	Dividend entitlement	Maximum rate of tax (with 15% surcharge)	Income tax on dividend income *	Net distribution to shareholder
Shareholder 1	5,000	1,50,40,000	35.88%	53,96,352	96,43,648
Shareholder 2	3,000	90,24,000	35.88%	32,37,811	57,86,189
Shareholder 3	2,500	75,20,000	35.88%	26,98,176	48,21,824
Shareholder 4	4,000	1,20,32,000	35.88%	43,17,082	77,14,918
Shareholder 5	3,000	90,24,000	35.88%	32,37,811	57,86,189
Shareholder 6	4,500	1,35,36,000	35.88%	48,56,717	86,79,283
Shareholder 7	3,000	90,24,002	35.88%	32,37,812	57,86,190
	25,000	**7,52,00,002**		**2,69,81,761**	**4,82,18,241**

In all above cases tax cost is more than Rs. 2 Crore. Such cost can be substantially reduced if buy back scheme is developed and used as follows:

Particulars	Rs.
Equity share capital	10,00,000
Reserves and surplus as on 31-Mar-2020	30,00,00,000
Total equity as per unaudited financial statements for FY 2019-20 (Refer Note 1)	**30,10,00,000**
Total no. of equity shares issued, subscribed and fully paid up	25,000
Book value per equity share (assumed to be fair value for this calculation - Refer Note 2)	**12,040**
Total debt	**7,10,00,000**
Debt : Equity ratio (D / E) before buy-back of equity shares	**0.24**
Maximum buy-back of equity shares permissible	25.0%
Maximum equity capital permitted to be bought back (Refer Note 3)	**7,52,50,000**
No. of equity shares that can be bought back at book value (Refer Note 2)	**6,250**
Book value of equity shares that can be bought back by the company	**7,52,50,000**
Revised equity of the company after buy back	22,57,50,000
Total debt	7,10,00,000
Debt : Equity ratio (D / E) after buy-back of equity shares	**0.31**
Income tax to be paid by the company under section 115QA of the Income Tax Act, 1961	23.2960%
Income tax liability of the company under section 115QA (Refer Note 3)	**1,75,30,240**

***Note 1**: The equity capital eligible for buy back has been considered based on the audited financial statements of the company for FY 2019-20.*

***Note 2**: For the purpose of buy-back of equity share, the company needs to ascertain fair value thereof before undertaking buy-back from an IBBI registered valuer. The exact number of equity shares to be bought back can be decidsed based on the same.*

***Note 3**: Income tax liability of the equity shareholders is Nil under section 10 (34A) of the Income Tax Act, 1961.*

Hence, shareholders effectively pay taxes of Rs. 1.75 Crore under buyback scheme and hence can be beneficial to withdraw excess cash in the company most effectively.

Buyback - Presentation under Ind AS

If an entity re-acquires i.e. buys back its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity. The amount of treasury shares held is disclosed separately either in the Balance Sheet or in the notes, in accordance with Ind AS 1. An entity provides disclosure in accordance with Ind AS 24, if the entity reacquires its own equity instruments from related parties.