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Time for stock market-related tax exemptions to go

Doing away with the DDT and taxing dividends directly as income of shareholders will bring about a measure of equity in taxation

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With the Union Budget only a few days away, and the stock markets touching new highs, there have been news reports about discussions that some economists and others have had with the Central Board of Direct Taxes (CBDT) and the finance ministry regarding removal or phasing out of some of the stock market investment-related tax exemptions.

Today, there are two primary exemptions available for stock market investments, and one concession: exemption for dividends and for long-term capital gains on stock market sales of equity shares, and a lower rate of tax on short-term capital gains on stock market sales of equity shares.

The exemption for dividends is not really an exemption. The company paying the dividends pays a dividend distribution tax (DDT) on such dividends. This DDT is paid by grossing up the actual dividends paid. Since the company would consider such DDT as part of th total payout, the actual dividend distributed would be lower, and the DDT is in effect borne by the shareholders in the form of lower dividends. Further, a shareholder receiving dividends of more than Rs10 lakh in a year is further subject to an income tax at 10% of such dividends.

This system effectively ensures that there are just two rates of tax on dividends: one for shareholders receiving dividends of less than Rs10 lakh (only DDT), and another for shareholders receiving dividends of more than Rs10 lakh (DDT plus 10%). This is inequitable, particularly for shareholders in the lower tax slabs. Such shareholders, whose income may be below the exemption limit or otherwise

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taxable only at 10%, bear the same amount of tax on the dividends as a shareholder in the 30% tax bracket, assuming that both of them receive dividends of less than Rs10 lakh.

Doing away with the DDT and taxing dividends directly as income of shareholders will therefore bring about a measure of equity in taxation, and would therefore be a welcome measure. It would also reduce the litigation arising from disallowance of expenses currently being made by the tax authorities, on the ground that they relate to the exempt income of dividends, though such dividends are economically taxed. The only trouble for investors would be that shareholders would need to compile details of dividends every year while filing their income tax returns.

The other stock market equity-related provision is the long-term capital gains exemption (and the short-term capital gains concessional tax rate) for equity shares sold on the stock market, with securities transaction tax (STT) being levied on all stock market transactions in lieu thereof. Like all tax exemptions in the past, this tax exemption too has been used to launder black money, through manipulated stock market transactions. Investors have also been resorting to bonus stripping, using it as a tax shelter against their other taxable capital gains. Of course, the capital gains exemption has helped expand the equity markets by creating substantial interest in investing in equity shares amongst the general public.

The government perhaps now feels that the disadvantages far outweigh the advantages. Further, most investors have realised that the returns from equity share investing are today far higher than the returns one can make from other investments. A view is therefore prevalent that there is really no need to further subsidise such investments through tax benefits.

One hears different rumours on what the changes are likely to be. Some talk of extending the holding period in order to qualify for long-term capital gains exemption from 1 year to 2 or 3 years, others talk of introduction of a concessional rate of 10% on such gains to replace the exemption, while yet others talk of complete withdrawal of the exemption and the associated STT.

Like corporate income tax concessions, which were phased out in a timebound manner with advance notice given to taxpayers, the government would do well to phase out this exemption too over a period of time, announcing the roadmap now. This would give investors an opportunity to reconsider and reconfigure their investment portfolios in a planned manner, and would not create a shock in the stock markets with panic selling of equities, which a sudden withdrawal of exemption would cause. However, such changes would definitely rationalise and simplify the taxation of such incomes.

Any change in such taxation will definitely have an impact on the stock markets, which are currently experiencing a boom. With this being the last Union Budget before the general election in 2019, it is likely that the government would not want to rock the boat too hard, particularly if it adversely impacts the large urban middle class. One will therefore have to wait till 1 February 2018 to see what exactly lies in store for stock market investors on this front.

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