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Unit IV

DIVIDEND POLICY
&
TAXATION

In ordinary language dividend means the sum received by a share holder of a company on the distribution of its profits.

Dividend decision of the company is crucial area of financial management. Dividend policy mainly concern with payment ratio and growth rate. This important concept can understand by example : Suppose two companies, (LPOC & HPOC) both have a return on equality (ROE) of 20 percent. Assume that both companies equilty value each ₹ 100. High payout company (HPOC) distributes 80% and low pay out company distribute 20% of its earnings as dividends.

The percentage of earnings paid as dividends is called payout ratio. A high payout rates means more dividends and less funds for expansion and growth. A low payout, on the other hand, result in a higher growth.

* Does dividend policy effect the market value of the firm?

Whether dividend will increase value or not may depend on the profitable investment opportunities available to the firm. In Walter's view it depends on the profitability of investment opportunities valuable to the firm and the cost of capital. If the firm has profitable opportunities, its value will be maximum when 100 per cent of earning are retained. Gordon also arrives at the same conclusion. Yet another view is that because of uncertainty of capital gains, investor like more dividends. This implies that the market price of share of high payout companies will command premium.

Modigliani and Miller do not agree with the view that dividends effect the market value of shares. According to them if investment policy is given, then dividend policy is a trade-off between cash dividends and issue of equity shares. The price of share adjusted by the amount of dividend distributed. Thus, the existing shareholder is neither better off not worse off. His wealth remains unchanged. For their view, MM assume perfect capital market, no transaction costs and no taxes.

In ~~She~~ practical, world is not single, there exist transaction costs as well as taxes. In such a world one view is that investors like cash dividends.

Forms

Dividend may take two forms; cash dividend and Bonus share (stock dividend). Bonus shares cannot be issue in lieu of cash dividends. Bonus shares have a psychological appeal. They do not increase the value of shares.

Companies generally prefer to pay, cash dividends. The company's ability to pay dividend depends on its fund requirements for growth shareholder's desire and liquidity.

115-O According to section 1150 A domestic company knows about tax shield and is liable to pay tax on gross dividend declared or distributed or paid at the rats of 15 per cent plus surcharge @12% and education cess 3% it means total 17.304% tax (AY 2016-17), but shareholders get benefit as exemption under section 10(34) of IT Act any dividend received from domestic company.

Dividend received from foreign company and cooperation society is to be included in the income and are changeable to tax.