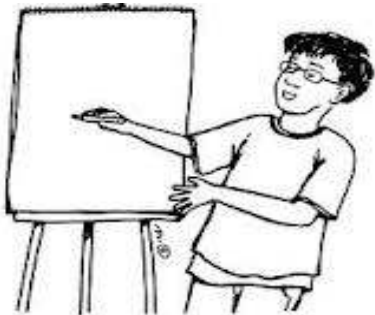


DEEMED DIVIDEND



Presented by:

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SESSION OVERVIEW

- Legislative History
- Dividend u/s 2(22)
- Deemed Dividend u/s 2(22)(e)
- Compliances By
 - Closely Held Company
 - Recipient Shareholder



LEGISLATIVE HISTORY

- Section 2(6A) of the Indian Income Tax Act, 1922
- Section 2(22) of the Income Tax Act, 1961
- Section 2(6A)(e) of the Indian Income Tax Act, 1922 was introduced for the first time by the Finance Act, 1955
- Section 2(22)(e) amended by the Finance Act, 1987 (w. e. f. 1-4-1988)

Constitutional Validity of Section 2(22)(e) - Upheld in Navnitlal C. Jhaveri v K K Sen, AAC [1965] 56 ITR 198 (SC)

DIVIDEND u/s 2(22) includes –

(a)

- distribution entails the release of all or any part of the assets of the company

(b)

- distribution of debentures, debenture-stock or deposit certificates in any form, whether with or without interest

(c)

- distribution by a company on its liquidation

(d)

- distribution by a company on the reduction of its capital

(e)

- payment by a Closely Held Company by way of advance or loan to a shareholder who is a beneficial owner of shares holding not less than 10% of the voting power

Accumulated
Profits,
whether
capitalized or
not

IS IT DEEMED DIVIDEND?

- Ironically, the word “Deemed” is not used even once in the Section 2(22).
- In this Section 2(22), certain payments by the Company to shareholder are construed as Dividend which would not be dividend under the Ordinary commercial parlance or ‘The Companies Act, 1956’ and hence the term ‘Deemed Dividend’.
- In *Kantilal Manilal v. CIT* (1961) 41 ITR 275 (SC), Held that Section 2(22) creates a fiction by which certain receipts or parts thereof are treated as dividend for the purpose of levy of Income-tax .

PURPOSE

- Section 2(22)(e) of the Income Tax Act, 1961 plainly seeks to bring within the tax net accumulated profits which are distributed by closely held companies to its shareholders in the form of loans. The purpose being that persons who manage such closely held companies should not arrange their affairs in a manner that they assist the shareholders in avoiding the payment of taxes by having companies pay or distribute, what would legitimately be dividend in the hands of shareholders, money in the form of advance or loan.
 - Read in CIT v. Raj Kumar (2009) 181 Taxmann 155 (Delhi).



WHEN A PAYMENT IS DEEMED DIVIDEND?



SCOPE – Section 2(22)(e)



- 1 TYPE OF COMPANY
- 2 NATURE OF PAYMENTS
- 3 PERSONS COVERED
- 4 AMOUNT
- 5 ACCRUAL

1

TYPE OF COMPANY

- a Closely Held Company i.e., a Company in which the public is not substantially interested.
- A Closely Held Company will include -
 - a Private Company (as defined in The Companies Act, 1956
 - a company not being a Private Company (as defined in the Companies Act, 1956), whose Equity Shares were NOT listed on the 31 March of the previous year in a Recognised Stock Exchange.
[See Section 2(18)(f) of the I. T. Act, 1961]

1

Company in which Public is substantially interested ?

Section 2(18) defines “A Company in which public is substantially interested” to include:

- a. a company owned by the Government or the RBI or more than forty percent of the shares are owned by Government or the RBI or a corporation owned by the RBI.
- b. a company registered under section 25 of the Companies Act, 1956.
- c. a company not having share capital and declared by the Board to be such company
- d. Mutual Benefit Finance Company - business of acceptance of deposits from members and notified by the Central Government u/s 620 of the Companies Act, 1956.
- e. a company, whose more than 50% Equity Shares (not being Preference Shares) held by one or more Co-operative Societies throughout the previous year.
- f. a company not being a Private Company as defined in the Companies Act, 1956, whose Equity Shares were listed on the 31 March of the previous year in a Recognised Stock Exchange.
- g. a ‘Government Company’ not being a ‘Private Company’ (both terms being defined in the Companies Act, 1956).

1

IF FOREIGN COMPANY?

- Section 2(22)(e) does not distinguish between an Indian or a Foreign Company.
- Section 2(17) defines “company” to include a body corporate incorporated by or under the laws of a country outside India.
- Sum paid by a Foreign Company to a resident shareholder has been held as dividend
- See *Gautam Sarabhai v. CIT* (1964) 52 ITR 921 (GUJ.)



2

NATURE OF PAYMENTS

(i) Any payment by way of advance or loan; OR

Exception: Loan or advance is granted in the ordinary course of its business and lending of money is a substantial part of the company's business. (See Section 2(22)(ii))

(ii) Any payment, on behalf of, or for the individual benefit of such Shareholder.

2

What is Loan or Advance?

- The term “Loan or Advance” has not been defined under the Income Tax Act, 1961.
- According to Black's Law Dictionary,
loan means a lending; delivery by one party to and receipt by another party of sum of money upon agreement, express or implied, to repay it with or without interest.

2

What is Loan?

In the matter of G.R. Govinda Rajolu Naidu v CIT (1973) 90 ITR 13 (Mad), HELD :

- There should be an outgoing or flow of money from the company to the shareholder
- a notional payment by way of book entries will not be included.
- The amounts due by the assessee to the company towards the first and second call monies on the shares held by it in the company - Not Deemed Dividend u/s 2(6A)(e) of the Indian Income Tax Act, 1922

2

What is Advance?

- The Black's Law Dictionary defines the term "advance" as "a payment made in anticipation of a contingent or fixed future liability or obligation". Ordinarily, an advance is a payment beforehand and it does not connote the idea of repayment. It is adjusted when the action, for which the money is advanced, is completed
- Advances means something which is due to a person but which is paid to him ahead of the time when it is due to be paid.
[CIT v Srinivasan (K.) (1963) 50 ITR 788 (Mad)].

2

What is Loan or Advance?

In the matter of CIT v. Raj Kumar (2009) 181 Taxmann 155 (Delhi), Held:

- The usual attributes of a loan are that it involves positive act of lending coupled with the acceptance by the other side of the money as loan - it generally carries interest and there is an obligation of repayment.
- The term 'advance' is of wide import & has undoubtedly more than one meaning, depending on the context in which it is used. In its widest meaning, the term 'advance' may or may not include lending or the obligation of repayment.
- The Delhi High Court applied the rule of construction of noscitur a sociis - "the meaning of the word can be gathered from the context" or "by the company which it keeps."
- The word 'advance' which appears in the company of the word 'loan' could only mean such 'advance' which carries with it an obligation of repayment.
- Trade advance which are in the nature of money transacted to give effect to a commercial transactions would not fall within the ambit of the provisions of Section 2(22)(e) of the Act.

2

Advance – Example 1

In the matter of CIT v P.K. Abubucker (2003) 259 ITR 507 (Mad):

Facts A company had advanced to a shareholder a sum for construction of a building to be taken on lease, and the amount so advanced was to be adjusted against future rent.

Held Liable to be assessed as Deemed Dividend.

2

Advance – Example 2

In the matter of Dr. Shiv Kant Mishra v Dy CIT (2009) 118 ITD 347 (Luck):

Facts A MoU was entered into between the assessee and the company whereby the company advanced money to the assessee for purchase of land and, in turn, he was to transfer by way of lease a portion of land in favour of the company. Factually, the assessee constructed a residential building for his personal use on the said land.

Held Tribunal held that neither the business of the company was to carry on construction or deal in real estate nor did the assessee's case fall in the exception provided in section 2(22). The Tribunal held that the MoU between the company and the assessee was a colourable device adopted for transfer of accumulated profits as loan for an indefinite period. Accordingly, the inclusion of such amount as deemed dividend in the hands of the assessee was upheld by the Tribunal. Thus, the decision went in favour of the revenue.

2

Included in Loans Or Advances

Account Head	Citation
Advances in Kind	M.D. Jindal v. CIT [1986] 28 Taxman 509 (Cal.)
Trade Advances	CIT v Jamnadas Khimji Kothari (1973) 92 ITR 105 (Bom)

2

NOT - Loans Or Advances

Account Head	Citation
Imprest Balances with Directors	ACIT v Harsad V. Doshi (2011) 49 DTR 181 (Trib) (Chennai)
Deposits	ACIT v Global Agencies Pvt. Ltd. 87 TTJ 1086 (Del)
Inter-Corporate Deposits	Bombay Oil Industries Ltd. v DCIT (2009) 28 SOT 383 (Mum)
Trade Advances	CIT v. Raj Kumar (2009) 181 Taxmann 155 (Delhi)

2

EXCLUSION – LOAN OR ADVANCE IN THE ORDINARY COURSE OF BUSINESS

Clause (ii) of Section 2(22) -

“... but “dividend” does not include -

- (ii) any advance or loan made to a shareholder or the said concern by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the company; ... ”

2

EXCLUSION – LOAN OR ADVANCE IN THE ORDINARY COURSE OF BUSINESS

Two cumulative conditions -

- (i) Advance or loan made to shareholder is in the “ordinary course of business”; and
- (ii) Lending of money is a substantial part of the business of the company;

'Ordinary course of business' shall mean that the loan or advance should be given to such shareholder at the same rate and terms as it is given to other borrowers.

- CIT v V.S. Sivasubramaniam (1998) 231 ITR 656 (Mad)]

Merely because the company did not have any money lending licence, lending of money will not be treated as deemed dividend, if the assessee was lending money in the ordinary course of its business.

-Jhamu V. Sughend v DCIT (2006) 284 ITR (AT) 82 (Mum).

2

EXCLUSION – LOAN OR ADVANCE IN THE ORDINARY COURSE OF BUSINESS

“substantial part of business of the company” is not defined under the Income Tax Act, 1961

In CIT v. Parle Plastics Ltd. (2011) 196 Taxmann 62 (Bom.), Held

- Stroud’s Judicial Dictionary defines “substantial” as “A word of no fixed meaning, it is an unsatisfactory medium for carrying the idea of some ascertainable proportion of the whole”.
- “substantial” does not mean “major”
- Various factors to be looked into to determine whether the business is substantial or not, namely-
 - Turnover
 - Profits
 - Capital Employed
 - Human Resources

2

PAYMENTS ON BEHALF OF OR FOR THE INDIVIDUAL BENEFIT OF SUCH SHAREHOLDER

In the matter of CIT v. L. Alagusundaram Chettiar[1977] 109 ITR 508 (Mad.),

Facts A managing director of a company, whenever he needed money used to ask an employee to take a loan from the company and the company would pass it on to the employee even without executing any pronote. The employee advanced the loan to the assessee almost immediately and in toto.

Held The loans made by the company to the employee fell in the category of “benefit” to the assessee managing director and were, therefore, assessable as deemed dividends in his hands.

2

PAYMENTS ON BEHALF OF OR FOR THE INDIVIDUAL BENEFIT OF SUCH SHAREHOLDER

In the matter of *Nandlal Kanoria v. CIT* [1980] 122 ITR 405 (Cal.),

Facts The assessee, having substantial interest in a company X, obtained from company Y two loans of Rs. 75,000 and Rs.2,00,000 on July 30, 1968 and September 2, 1968, respectively. Y had made the loans of Rs. 75,000 to the assessee out of loans received by Y from X on the same date. Further, Y had made the loans of Rs. 2,00,000 to the assessee out of loans received by Y from X and another source on the same date.

Held This amount of Rs. 75,000 was a payment by X for the benefit of the assessee and fell within the mischief of section 2(22)(e). The same could not be said of the loan of Rs. 2,00,000, as on the date of making that loan, Y had received loans not only from X but from another source also and the loan was made out of blended amount.

3

PERSONS COVERED

- (i) Any shareholder who is a beneficial owner of 10% or more of Voting power of the Company (but the shares shall not be entitled to a fixed rate of dividend, whether with or without a right to participate in profits); Or
- (ii) (a) To a concern (includes {HUF, Firm, AOP or BOI, Company}) in which such shareholder is a partner or a member , AND;
 - (b) has substantial interest (when entitled to 20% or more of the income of such concern).



3

SHAREHOLDER v. BENEFICIARY

- Shareholder - means a Registered Shareholder - whose name appears in the Register of Member u/s 150 of The Companies Act, 1956
[Rameshwarlal Sanwarmal v CIT (1980) 122 ITR 1 (SC)]
- Beneficiary - whose name does not appear in the Register of Member u/s 150 but has a beneficial interest in such shares by virtue of Declarations furnished u/s 187-C of The Companies Act, 1956.

3

SHAREHOLDER & BENEFICIARY

In case of non-corporate entities, such as Trusts (Public Charitable or Private), Hindu Undivided Family, Partnership Firms, etc the shares are held in the name of Trustees, Karta (Manager) or the Partner, respectively, whereas the beneficial owner of the Shares is the respective Entity.

Section 2(22)(e) applies only in case

- The beneficiary and the shareholder are the same person and not applicable in case
- The beneficiary is not the Registered Shareholder ; or
- The Registered Shareholder is not the beneficiary.
 - CIT v. C P Sarathy Mudaliar (1972) 83 ITR 170(SC)
 - ACIT v. Bhaumick Color (P) Ltd. (2009) 118 ITD 1 (MUM.) (SB)
 - CIT v. National Travel Services (2011) 202 Taxmann 327 (Delhi)

3

VOTING RIGHTS > 10%

- Shareholder who is a beneficial owner of 10% or more of the Voting Power of the Company - on the date of loan or advance.
- Section 86(a)(ii) of 'The Companies Act, 1956' permits shares with Differential Rights as to Dividend, Voting or otherwise.
- In such case, The Voting Right of the shareholder must be more than 10% of the Total Possible Votes of all classes of Share Capital (other than Preferred Share Capital)
- Even if the whole or part of dividend on the preferred capital is remaining unpaid, and by virtue of Section 87(b) of 'The Companies Act, 1956', a preferred shareholder is entitled to vote, these shares are to be excluded if such shares are entitled to a fixed rate of profit.

3

PAYMENT TO CONCERN OF SHAREHOLDER

A person shall be deemed to have a substantial interest in a concern, at any time during the previous year,

- (a) other than a company if he is, beneficially entitled to not less than 20% income of such concern.
- (b) In the case of a company, if he beneficially holds atleast 20% equity capital of the company.

Explanation 3(b) to Section 2(22).

3

PAYMENT TO CONCERN OF SHAREHOLDER

If the loan or advance is given to a concern (HUF, Company, Firm, AOP or BOI) in which the shareholder and beneficiary has a substantial interest, then the deemed dividend u/s 2(22)(e) will be included in the Total Income of

THE SHAREHOLDER and
NOT THE CONCERN

- ACIT v. Bhaumick Color (P) Ltd. (2009) 118 ITD 1 (MUM.) (SB)
- CIT v Universal Medical Pvt. Ltd. (2010) 190 Taxman 144 (Bom)
- CIT v. Ankitech (P) Ltd. (2011) 11 taxmann.com 100 (Delhi)
- CIT v. National Travel Services (2011) 202 Taxmann 327 (Delhi)

Circular No. 495 dated 22-9-1997 issued by CBDT - making payments to be included in the Total income of the concern over-ruled.

3

NON-RESIDENT SHAREHOLDER

- Section 2(22)(e) does not distinguish between a Resident or Non-resident shareholders.
- Further, it is pertinent to note that by virtue of Clause (iv) sub-section (1) of section 9, “any dividend paid by an Indian company outside India” is ‘Income deemed to accrue or arise in India’.
- Therefore, Deemed Dividend u/s 2(22)(e) is subject to tax in India in the hands of a Non-resident Shareholder subject to DTAA relief.



4

AMOUNT DEEMED AS INCOME

Amount of Advance or Loan.

Subject to maximum of Accumulated Profits .

4

ACCUMULATED PROFITS

- In the matter of P. K. Badiani v. CIT (1976) 105 ITR 642 (SC), Held:

Accumulated profits mean commercial profits and not assessed income....It does not mean the aggregate of the assessed income arrived at after disallowing disbursements and expenditure in fact incurred..

- Exception

In Navnitlal C. Jhaveri v. CIT[1971] 80 ITR 582(Bom), Held:

While calculating accumulated profits, an allowance for depreciation at the rates provided by the Income-tax Act itself has to be made by way of deduction.

4

CURRENT YEAR – PROFIT

Explanation 2 - The expression “accumulated profits” shall include all profits of the company up to the date of distribution or payment referred to in sub-clauses (a), (b), (d) & (e)

However, the Supreme Court has held, “The profit accruing during the year cannot be considered as an accumulated profit for the purpose of section 2(22).”

- CIT v. M.V. Murugappan (1970) 77 ITR 818 (SC)
- CIT v. Ashokbhai Chimanbhai (1965) 56 ITR 42 (SC)
- E.D. Sassoon & Co. Ltd. v. CIT (1954) 26 ITR 27 (SC)

4

NOT - ACCUMULATED PROFITS

Account Head	Citation
Securities Premium	CIT v. MAIPO India Ltd. (2008) 24 SOT 42 (Delhi)
Share Forfeiture Receipts	Navnitlal C. Jhaveri v. CIT (1971) 80 ITR 582(Bom)
Profit / (Loss) for the Current year	CIT v. M V Murugappan (1970) 77 ITR 818 (SC)
Balancing Charge u/s 41(2)	CIT v. Urmila Ramesh (1998) 96 TAXMAN 533 (SC)
Additions made by AO	P. K. Badiani v. CIT (1976) 105 ITR 642 (SC)
Capital Gains (if Exempt)	CIT v. Mangesh J. Sanzgiri, (1979) 119 ITR 962(Bom)
Provision for Tax and Dividend	CIT v V. Damodaran (1972) 85 ITR 59 (Ker.).

4

INCLUDED IN ACCUMULATED PROFITS

Account Head	Citation
General Reserves	CIT v. Srinivasan K. (1963) 50 ITR 788 (Mad.)
Profits generated from Exempt Income or Agricultural Income	Tea Estates India (P.) Ltd. V. CIT (1976) 103 ITR 785 (SC) S. Kumaraswami v. ITO [1961] 43 ITR 423 (Mad.)
Capital Gains (other than Exempt)	Explanation 1 to Section 2(22)
Investment Allowance Reserve	
Development Rebate Reserve	

4

PROFITS EARLIER DEEMED AS DIVIDEND

- In the matter of CIT v. G. Narasimhan (1979) 118 ITR 60 (Mad), Held:

In determining the Accumulated profits available for the purpose of section 2(22)(e), the amount treated as deemed dividend under section 2(22)(e) in past have to be excluded, irrespective of the fact that no adjustment is made in the books of accounts.

Similar view expressed in P. K. Badiani v. CIT (1976) 105 ITR 642 (SC)

4

AMOUNT

NOT RESTRICTED TO SHAREHOLDER'S SHARE IN ACCUMULATED PROFITS

- CIT v. Mayur Madhukant Mehta (1972) 85 ITR 230 (Guj.)
- CIT v. Bhagwat Tewari (1975) 105 ITR 62 (Cal.)
- CIT v. Arati Debi (1978) 111 ITR 277 (Cal.)

5

ACCRUAL

“Deemed Dividend” accrues in the ‘previous year’ in which the payment was made. (Section 8(a)).

- Therefore, only payment(s) made during the “current year” is covered & any outstanding balances / interest on loans are to be ignored.

5

ACCRUAL

In CIT, Panaji - Goa v. Parle Plastics Ltd. (2011) 196 Taxmann 62 (Bom.), HELD:

- Only that amount of loans & advances, which was actually received by the assessee by way of loan or advance during the relevant previous year, could be treated as income by way of 'deemed dividend' and the carried forward balance of the loan of the previous year could not be treated as deemed dividend.



COMPLIANCES – CLOSELY HELD COMPANY

Corporate Dividend Tax – Not Applicable

TDS under Section 194

Disclosure in Audit Report

Set-Off to avoid Double Taxation

Corporate Dividend Tax – Not Applicable

- Provisions of Tax on Distributed Profits of Domestic Company (or Corporate Dividend Tax) (Section 115-O) are not attracted in case of “Deemed Dividend” u/s 2(22)(e).
[See Explanation to Chapter XII-D of the I. T. Act, 1961 - appears below Section 115-Q.]
- And as a consequence thereof,
 - Exemption u/s 10(34) in respect of Dividends declared by Domestic Companies is not available.
 - TDS u/s 194 is applicable

TDS u/s 194

- Tax Deduction u/s 194
- by the principal officer of an
 - Indian Company or
 - ‘a foreign Company which has made arrangement for payment of dividends in India’
- at the rate in force,
- before making any payment of any sum deemed to be dividend u/s 2(22)(e) of the I. T. Act, 1961.

- Rule 27 - I T Rules, 1962 details the “prescribed arrangements for payment of dividends within India”

Failure To Deduct Tax u/s 194 - Consequences

- No disallowance u/s 40(ia) of the I. T. Act, 1961
- The company may be liable to penalty u/s 271C(1)(a) of an amount equal to the 'amount of tax' it has failed to deduct.

DISCLOSURE IN AUDIT REPORT u/s 44AB

- No specific provision in the Audit Report Form No. 3CD prescribed by the Income Tax Rules, 1962 for reporting of 'Deemed Dividend' paid by a Company.
- However, Clause 27 of Form No. 3CD requires the auditor to disclose whether the assessee has complied with the provisions of Chapter XVII-B relating to Deduction of Tax at Source.
- Since as per the preceding slide Tax is required to be deducted by the principal officer of an Indian Company u/s 194, the Auditor is obliged to report of Non-deduction of TDS u/s 194 in the Audit Report Form No. 3CD.



SET-OFF TO AVOID DOUBLE TAXATION

- Subsequently, when the company declares dividend, &
- any such dividend is set-off against the advance,

then

- the dividend so adjusted against the advance (which has been deemed as dividend), will not be again treated as dividend.

(See Section 2(22)(iii))

- If the dividend is not so set off but is paid to the shareholders while the loan remains outstanding, the benefit of this exception cannot be obtained.

[Walchand & Co. Pvt. Ltd. v CIT (1993) 204 ITR 146 (Bom)].

COMPLIANCES – RECEPIENT SHAREHOLDER

Head of Income & Rate of Tax

Assessment – Burden of Proof

HEAD OF INCOME & RATE OF TAX

- Deemed Dividend is taxed under the head
 - [Shares are held as Investment] - Income from Other Sources. [See Section 56(2)(i) of the Income Tax Act, 1961], or
 - [Shares are held as Stock-in-Trade] - Profits and Gains from business / profession
- No special rate of tax is applicable to deemed dividend and it is taxed as income chargeable to tax at normal rates.
 - i.e., slab rates in case of individuals & HUF's .

ASSESSMENT – BURDEN OF PROOF

- The burden is on the Revenue to prove that the case is falling within the mischief of the deeming provision u/s 2(22)(e) of the Income Tax Act, 1961.
 - See Subrata Roy Sahara v. ACIT Central Circle III, Lucknow (2007) 109 ITD 1 (Luck) (TM)
- If the assessee is claiming any exception, say
 - Loan or advance is in due course of the business, and lending is substantial part of the business ; or
 - Loan or advance is set-off against dividend declared subsequently;then the burden is on the assessee to prove that the case is falling within the exception to the deeming provision u/s 2(22)(e) of the Income Tax Act, 1961.
 - Walchand & Co. Ltd. v. CIT (1975) 100 ITR 598 (Bom)



QUESTIONS
AND
Answers

Presented By: CA. Nirmal Ghorawat

Q1

Type of Company		Shareholder's Residential Status	Applicability of Sec 2(22)(e)
Indian Company	-->	Resident	Yes
Foreign Company	-->	Resident	Yes
Indian Company	-->	Non-Resident	Yes
Foreign Company	-->	Non-Resident	??

Q2 Mutual, Open and Current Account

Series of payments & repayments during a year.

Thank
you