

Implications of section 2(22)(e)

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1. Introduction

Dividend in common parlance means the amount paid to a shareholder by a company in proportion to his shareholding in that company. However, section 2(22) of the Income Tax Act provides the inclusive definition of dividend and imparts much wider connotation to the term dividend. For example, as per section 2(22)(e), even loans given to a shareholder (under certain circumstances) are treated as dividend though under the common law, a loan which is repayable to the lender cannot be said to be dividend. Dividends are generally exempt from tax as per section 10(34) in the hands of recipients but the domestic companies declaring, distributing or paying dividend are liable to pay additional income tax at the rate of 15% on dividends declared/ paid. However, as per section 115Q, “deemed dividend” u/s 2(22)(e) is not subjected to tax in the hands of the company concerned but the same is chargeable to tax in the hands of recipients as “Income from other sources”.

2. Relevant provisions concerning “deemed dividend”

Clause (e) of section 2(22) provides as under-

“(22) dividend includes-

any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent. of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits;

This provision further provides six exclusions out of which two are directly related to clause (e) of section 2(22). These two exclusions are set out as under-

“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;

(iii) any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e), to the extent to which it is so set off;

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The three “Explanations” appended to the provision, which provide definitions/certain clarifications to the expression used in the provision are also stated below for the sake of clarity-

Explanation 1.- The expression "accumulated profits", wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948, and before the 1st day of April, 1956.

Explanation 2.- The expression "accumulated profits" in sub-clauses (a), (b), (d), and (e), shall include all profits of the company up to the date of distribution or payment referred to in those sub-clauses, and in sub-clause(c) shall include all profits of the company up to the date of liquidation but shall not, where the liquidation is consequent on the compulsory acquisition of its undertaking by the Government or a corporation owned or controlled by the Government under any law for the time being in force, include any profits of the company prior to three successive previous years immediately preceding the previous year in which such acquisition took place.

Explanation 3. - For the purposes of this clause, -

(a) "concern" means a Hindu undivided family, or a firm or an association of persons or a body of individuals or a company;

(b) a person shall be deemed to have a substantial interest in a concern, other than a company, if he is, at any time during the previous year, beneficially entitled to not less than twenty per cent. of the income of such concern;

3. Section 2(22)(e) made easy

A cursory glance at the provisions stated above shows their cumbersome nature. Attempt is made to simplify the same.

As per the provision of section 2(22)(e), following types of payments are treated as “dividend” to the extent of accumulated profits-

- (i) Loan to a shareholder or payment on behalf of or for the benefit of a shareholder.
- (ii) Loan or advance to a concern.

Conditions to be satisfied in case (i) are as under-

Case (i) –

Loan or advance to a shareholder is treated as dividend in the hands of shareholder if the following conditions are satisfied:

- (a) payment by way of loan or advance is given by a company in which the public are not substantially interested;*
- (b) payment is made after May, 31, 1987 by way of loan or advance to a shareholder (being a person who is a registered shareholder as well as the beneficial owner of at least 10 percent equity shares):*
- (c) the company should possess accumulated profits (excluding capitalized profits) at the time it makes payment of loan or advance*

If all the aforesaid conditions are satisfied, the payment of loan or advance is treated as dividend to the extent the company possesses accumulated profits.

Conditions to be satisfied in case (ii) are as under-

Case (ii)-

Loan or advance given to a concern is treated as a deemed dividend u/s 2(22)(e) in the hands of the concern (may be HUF/ firm/ company/ AOP/BOI) if the following conditions are satisfied-

- (a) loan or advance is given by a company in which the public are not substantially interested;*
- (b) loan or advance is given after May, 31, 1987;*
- (c) the company should possess accumulated profits (excluding capitalized profit) at the time it makes payment of loan or advance; and*
- (d) loan or advance is given to a concern (i.e. a Hindu Undivided Family or a Firm or an Association of Persons or a Body of Individuals or a Company) in which a shareholder (which is a registered shareholder as well as beneficially holding at least 10 percent equity share capital) of the company (giving loan or advance) has substantial interest.

A person shall be deemed to have a substantial interest in a concern, if he is at any time during the previous year, beneficially entitled to at least 20% of income of such concern (if such concern is a company, then he should beneficially hold at least 20 percent equity share capital of the company).

It may be noted that conditions (a), (b) & (c) (given in italics) in both the cases (i) and (ii) are common conditions.

4. Relevant case laws

(a) Any sum given by the company to a shareholder (having more than 10 percent of the total voting power in the company) or to a concern in which the shareholder has substantial interest (meaning thereby 20 per cent stake in the concern) is taxable as deemed dividend only if the company has accumulated profits. If the company does

not possess profits before such loan or advance to the shareholder, nothing is taxable as deemed dividend. ***R. Dalmia v. CIT[1982] 133 ITR 169.***

(b) Where a shareholder receiving an advance, returns the advance subsequently, the taxability of deemed dividend cannot be avoided -

Smt. Tarulata Shyam v. CIT[1977] 108 ITR 345 (SC).

(c) The recipient of loan or advance from the company (not in the ordinary course of Business of the lender) may be another corporate entity. For example, X Co. (P) Ltd. may have a shareholder, namely, Y Co. (P.) Ltd. with 50 per cent stake in it. Loan or advance given by X Co. (P.) Ltd. to the shareholder will be treated as deemed dividend in hands of the shareholder. - ***Sadhana Textiles Mills (P.) Ltd. v. CIT [1991] 188 ITR 318 (Bom.).***

(d) Where the shares are gifted by a shareholder and the shareholding is reduced to less than 10 percent before the date of obtaining loan or advance from the company, section 2(22)(e) will not apply and the fact of delayed registration of gift of shares by the company will not affect the borrowing shareholder. The delay in registration of transfer of shares would relate back to the date on which the requisite forms were submitted to the company - ***CIT v. Smt. S. Parvathavarthini Ammal [1996] 219 ITR 661(Ker.).***

(e) In ***L. Alagusundaram Chettiar v. CIT [2001] 252 ITR 893(SC)***, the company advanced loans to an employee who was drawing low salary. The employee in turn advanced the money to the managing director of the company. The Court held that the loan advanced to the managing director through the employee was taxable as deemed dividend.

(f) Under sub clause (e), the word “shareholder” refers to the registered shareholder and not merely beneficial owner of a share and hence a loan granted to a beneficial owner of shares, who is not a registered shareholder, cannot be regarded as loan or advance to a

“shareholder” so as to fall within the mischief of section 2(22)(e)- **Rameshwarlal Sanwarlal vs. CIT [1980] 3 Taxman 1(SC).**

(g) A bona fide loan for a short duration is treated as dividend if all the conditions of section 2(22)(e) are satisfied- **CIT v. Bhagwat Tewari [1976] 105 ITR 62 (Cal.).**

(h) An overdraft taken by a shareholder from the company is treated as loan and taxable as dividend if conditions of section 2(22)(e) are satisfied-**CIT v. K. Srinivasan [1963] 50 ITR 788 (Mad.).**

(i) Section 2(22)(e) is applicable even if loan is given in kind-**M.D. Jindal v. CIT[1986] 28 Taxman 509 (Cal.).**

(j) Section 2(22)(e) covers not only advances and loans to shareholders but any other payments by the company on behalf of or for the individual shareholders, such as payments of shareholder's personal expenses, insurance premia, etc., to the extent of the accumulated profits of the company- **CIT v. K Srinivasan [1963] 50 ITR 788 (Mad.).**

5. Accumulated Profits- a judicial controversy

The provisions of the Act are silent as to whether “accumulated profits” are to be computed in accordance with the Income Tax Act or as per the Company Law.

In the following two cases, it was held that depreciation allowance for the purpose of computing “accumulated profits” has to be calculated as per the provisions of the Income-Tax Act-

- (i) **Navnitlal C. Jhaveri v. CIT [1971] 80 ITR 582 (Bom)**
- (ii) **CIT v. Jamnadas Khimji Kothari [1973] 92 ITR 105 (Bom).**

In the following cases, it was held that the accumulated profits should be assigned meaning as understood under the Companies Act-

- (i) **Hariprasad Jayantilal & Co. vs. V.S. Gupta, ITO [1966] 59 ITR 794 (SC)**
- (ii) **CIT vs. Urmila Ramesh [1998] 96 Taxman 533 (SC).**
- (iii) **Rajpal Bros. (P.) Ltd. v. CIT[1971] 80 ITR 463 (Bom.)**

(iv) ***PK Badiani v. CIT[1976] 105 ITR 642 (SC)***

6. Some recent pronouncements reducing the rigours of section 2(22)(e)

(a) In ***DCIT vs. Lakra Brothers (2007) 106 TTJ (Chd.) 250/162 Taxman 170 (Mag.)***, the facts were that the assessee-firm engaged in ready made garments business advanced certain sum from time to time to a sister concern 'A' which were adjusted against goods supplied. The advances were treated by the A.O. as "deemed dividend". The Tribunal held that the amount was advanced during the ordinary course of business for business expediencies. So it cannot be said that there was intention of the company to give a loan. The Tribunal confirmed the action of CIT(A) in deleting the addition.

(b) In ***Sri Satchidanand S. Pandit vs. ITO (2008) 19 SOT 213 (Mum.)***, the A.O. treated the amounts payable by the assessee to 'H' on account of printing job done as "deemed dividend". The Tribunal held that the transaction in question was entered into during regular course of business between 'H' and assessee and was not entered into for the benefit of the assessee. The A.O. was, therefore, wrong in treating the said amount as deemed dividend u/s 2(22)(e).

(c) In ***ITO vs. M/s Sree Ramkrishna Traders, ITA No. 848/K/2007, order dated 17.03.2008***, a case before ITAT, 'D' Bench, Kolkata, the facts were that the assessee received advances from 'C' Ltd., a company wherein partners of the assessee-firm had substantial interest. The advances amounted to Rs. 1.82 crores as on 31.03.2002 and the accumulated profit as on 31.03.2003 amounted to Rs. 70,93,836/-. The A.O. treated the advance amount as "deemed dividend" in A.Y.: 2003-2004. The Tribunal confirmed the CIT(A)'s finding that the loans and advances of Rs. 1.82 crore which were received in the A.Y.: 2002-2003 are deemed to have reduced the accumulated profit for the purpose of section 2(22)(e), thus, the same cannot be treated as "deemed dividend" in the A.Y.: 2003-2004.

(d) In ***M/s Shell Business (P) Ltd. Vs. ITO, ITA No. 1737/K/07, order dated 31.03.2008***, a case before ITAT, 'D' Bench, Kolkata, the facts were that the assessee company received loans from sister companies – 'M/s SCP Ltd.' and 'M/s SFC Ltd.' amounting to Rs. 1,45,000/- and Rs. 3,50,000/- respectively, which were treated as "deemed dividend". The A.O. rejected the assessee's contention that advancing of loan by the two

companies was in the ordinary course of their business and the same was their principal business also inasmuch as according to him, the fund utilization towards granting of loans and advances was less than 50% of total sources of funds. The Tribunal delved into the facts and held that the A.O. made wrong comparison by comparing deployment of funds in the business of loans & advances with the Investment activity.

The deployment of funds in purchase of shares, which were reflected in the Balance Sheet under the head "Investment" cannot be taken into consideration for the purpose of determining the nature of business activity. Further, it was seen that both the companies obtained NBFC certificate issued by the RBI u/s 45IA. Therefore, it was to be held that both the companies have a single business of granting of loans and advances. It was further seen that both the companies charged interest on the amount granted as loan to the assessee company. This showed that the loans were advanced in the ordinary course of business. Thus, the twin conditions envisaged in the "exception" clause have been satisfied. With these findings, the Ld. Tribunal deleted the additions made on account of deemed dividend u/s 2(22)(e).

(e) In *Smt. Nigam Chawla vs. ITO(2009)28 SOT 503(Delhi)*, it was held that only because assessee surrenders a loan as deemed dividend to avoid controversy and litigation, it could not be sole ground to treat it as deemed dividend.

An assessee is not expected to be well versed in law when it comes to dealing with the interpretation of a deeming provision. Therefore, in such a situation, a surrender made by the assessee under a mistaken impression of law could not be the sole ground for making an addition.

In the instant case, the amount received by the assessee as advance for supply of zippers was a commercial transaction. It could also not be said that any benefit had accrued to the assessee. Hence, addition of the surrendered amount as deemed dividend was not justified.

(f) In *Bombay Oil Industries Ltd. vs. Dy. CIT (2009) 28 SOT 383(Mum.)*, it was held that Inter-Corporate Deposits (ICDs) are different from loans and advances and would not come within the purview of deemed dividend u/s 2(22)(e).

(g) In *ITO vs. Sagar Sahil Investment (P) Ltd. 2009 120 TTJ 925 (Mum.)*, the facts were that one 'S' became the registered shareholder of the company much subsequent to

the event of taking loan from the company, it was held that such loan amount could not be treated as deemed dividend in his hands; the fact that prior to taking loan 'S' was beneficial owner of more than 10% shares in lender company was immaterial.

(h) In *CIT vs. Rajkumar (209) 318 ITR 462 (Delhi)*, Hon'ble Delhi High Court held that the word 'advance', which appears in company of word 'loan' in section 2(22)(e), can only mean such advance which carries with it an obligation of repayment; hence, a trade advance, which is in nature of money transacted to give effect to a commercial transaction, cannot be treated as 'deemed dividend'