

Special Bench Deemed Dividend Bhuamik Mumbai ITAT 27 SOT 270

Decision on 2(22)(e)

IN THE ITAT, MUMBAI BENCH 'E'

Assistant Commissioner of Income-tax, Circle-33

vs.

Bhaumik Colour (P) Ltd.

G.C. GUPTA AND N.V. VASUDEVAN, JUDICIAL MEMBER

AND S.V. MEHROTRA, ACCOUNTANT MEMBER

IT Appeal No. 5030 (Mum.) of 2004

[Assessment year 1997-98]

November 19, 2008

Section 2(22) of the Income-tax Act, 1961 - Deemed dividend - Assessment year 1997-98

Whether deemed dividend can be assessed only in hands of a person who is a shareholder of lender company and not in hands of a person other than a shareholder - Held, yes

Whether expression shareholder referred to in section 2(22)(e) refers to both a registered shareholder and beneficial shareholder and, thus, if a person is a registered shareholder but not beneficial shareholder then provisions of section 2(22)(e) would not apply and similarly if a person is a beneficial shareholder but not a registered shareholder then also provisions of section 2(22)(e) would not apply - Held, yes

Whether deeming provisions of section 2(22)(e) as it applies to case of loans or advances by a company to a concern in which it's shareholder has substantial interest, it based on presumption that loan or advances would ultimately be made available to shareholders of company giving loan or advance, and, therefore, intention of legislature is to tax dividend only in hands of shareholder and not in hands of concern - Held, yes

Words and phrases

The expression being a person who is beneficial owner of shares' occurring in section 2(22)(e) of Income-tax Act, 1961

Circulars and Notifications:

Circular No. 495 dated 23-9-1987

FACTS

The assessee-company, namely BCPL, took an interest bearing loan of Rs. 9 lakhs from another company UPPL. The Assessing Officer having noticed that though BCPL was not a shareholder of UPPL yet both the companies had one common shareholder, i.e., Narmadaben Nandlal Trust (NNT), and that the said trust was holding 20 per cent shares in BCPL and 10 per cent shares in UPPL, took the view that the impugned transaction of loan was covered by the second limb of provisions of section 2(22)(e). The assessee's contentions in this regard were that the aforesaid shares were held in the names of three trustees of NNT for and on behalf of the trust, that the beneficiaries of the trust NNT were five in number and none of the trustees were also beneficiaries of the trust that to invoke the second limb of the provisions of section 2(22)(e) the

primary condition was that NNT must be both a registered shareholder and also beneficial shareholder and that since the Trustees of NNT held the shares on behalf of the trust only as legal owners and were not the beneficial owners of the shares, the provisions of section 2(22)(e) could not be invoked. The Assessing Officer did not agree with the contentions of the assessee and taxed Rs. 9 lakhs in the hands of BCPL as deemed dividend.

On appeal, the Commissioner (Appeals) deleted the addition made by the Assessing Officer holding that NNT was not beneficial shareholder of shares in BCPL or UPPL and, therefore, the second limb of the provisions of section 2(22)(e) could not be applied vis-à-vis the assessee.

On revenue's appeal:

HELD

Section 2(32) defines the expression 'person who has a substantial interest in the company', in relation to a company, means 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, carrying not less than twenty percent of the voting power. [Para 15]

Under the Indian Income-tax Act, 1922, two categories of payment were considered as dividend, viz., (a) any payment by way of advance or loan to a shareholder was considered as dividend paid to shareholder or (b) any payment by any such company on behalf or for the individual benefit of a shareholder was considered as dividend. [Para 16]

In the 1961 Act, the very same two categories of payment were considered as dividend, but an additional condition, that payment should be to a shareholder being a person who is the beneficial owner of shares and who has a substantial interest in the company, viz., shareholding which carries not less than twenty percent of the voting power, was introduced. [Para 17]

By the 1987 amendment with effect from 1-4-1988, the condition that payment should be to a shareholder 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 was substituted. Thus, the percentage of voting power was reduced from twenty percent to ten percent. By the very same amendment a new category of payment was also considered as dividend, viz., payment to any concern in which such shareholder is a member or a partner and in which he has a substantial interest. Substantial interest has been defined to mean holding of shares carrying 20 per cent of voting power. [Para 18]

The provisions of section 2(22)(e) create a fiction bringing in amounts paid otherwise than as dividend into the net of dividends. Therefore, clause (e) of section 2(22) must be given a strict interpretation. In the instant case, there was no dispute that the companies which gave the loan or advance were one in which public was not substantially interested. Nor was there any dispute that these companies possessed accumulated profits to the extent of the loan or advance. [Para 19]

In view of the judgments of the Supreme Court in the cases of CIT v. C.P. Sarathy Mudalian [1972] 83 ITR 170 and Rameshwarlal Sanwarlal v. CIT [1980] 122 ITR 1 / 3 Taxman 1 (AP), it is clear that to attract the first limb of the provisions of section 2(22)(e) the payment must be to a person who is a registered holder of shares. As already mentioned the condition under the 1922 Act and the 1961 Act regarding the payee being a shareholder remains the same and it is the

condition that such shareholder should be beneficial owner of the shares and the percentage of voting power that such shareholder should hold has been prescribed as an additional condition under the 1961 Act. The words 'Shareholder' alone existed in the definition of Dividend in the 1922 Act. The expression 'Shareholder' has been interpreted under the 1922 Act to mean a registered shareholder. This expression 'Shareholder' found in the 1961 Act has to be, therefore, construed as applying only to registered shareholder. [Para 22]

In the 1961 Act the word 'Shareholder' is followed by the following words 'being a person who is the beneficial owner of shares'. This expression used in section 2(22)(e) both in the 1961 Act and in the amended provisions with effect from 1-4-1988 only qualifies the word 'Shareholder' and does not in any way alter the position that the shareholder has to be a registered shareholder. These provisions also do not substitute the aforesaid requirement to a requirement of merely holding a beneficial interest in the shares without being a registered holder of shares. The expression "being" is a present participle. A participle is a word which is partly a verb and partly an adjective. In section 2(22)(e), the present participle 'being' is used to describe the noun shareholder like an adjective. The expression 'being a person who is the beneficial owner of shares' is, therefore, a further requirement before a shareholder can be said to fall within the parameters of section 2(22)(e). In the 1961 Act, section 2(22)(e) imposes a further condition that the shareholder has also to be 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. It was not possible to accept the contention of the revenue that under the 1961 Act there was no requirement of a shareholder being a registered holder and that even a beneficial ownership of shares would be sufficient. [Para 23]

The expression 'shareholder being a person who is the beneficial owner of shares' referred to in first limb of section 2(22)(e) refers to both a registered shareholder and beneficial shareholder. If a person is a registered shareholder but not the beneficial shareholder than the provisions of section 2(22)(e) would not apply. Similarly if a person is a beneficial shareholder but not a registered shareholder then also the first limb of provisions of section 2(22)(e) would not apply. [Para 24]

The new category of payment which was considered as dividend introduced by the Finance Act, 1987 with effect from 1-4-1988 by the second limb of Section 2(22)(e) is payment 'to any concern in which such shareholder is a member or a partner and in which he has a substantial interest'. [Para 25]

The following conditions are required to be satisfied for application of the above category of payment to be regarded as dividend.

- (a) There must be a payment to a concern by a company.
- (b) A person must be shareholder of the company being a registered holder and 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. This is because of the expression 'Such Shareholder' found in the relevant provision. This expression only refers to the shareholder referred to in the earlier part of section 2(22)(e), viz., a registered and a beneficial holder of shares holding 10 per cent voting power.

(c) The very same person referred to in (b) above must also be a member or a partner in the concern holding substantial interest in the concern viz., when the concern is not a company, he must at any time during the previous year, be beneficially entitled to not less than twenty per cent of the income of such concern; and where the concern is a company he must be the owner of shares, not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits, carrying not less than twenty percent of the voting power.

If the above conditions are satisfied then the payment by the company to the concern will be dividend. [Para 26]

In the case of the assessee aforesaid conditions (b) and (c) were not satisfied in as much as NNT held shares in UPPL and BCPL only as a legal and registered owner but not as a beneficial owner. The three trustees of NNT held shares in UPPL and BCPL only as a legal and registered owner. They held shares for and on behalf of 5 beneficiaries of the trust who were different individuals. They were, therefore, not beneficial owners of the shares. Trust ownership is a peculiar instance of duplicate ownership. Trust property is, in fact, owned by two persons simultaneously in the sense that one is under an obligation to use the property for the benefit of the other. The ownership of the trustee called trust ownership is nominal rather than real. The beneficiary interest is called the beneficial interest. The trustee is to administer the property of another person but the ownership right in the trustee is to be used only on behalf of the real owner. As between trustee and third party ownership conferred on the trustee fictitiously by law prevails, that is, the trustee is clothed with the rights of the beneficiary and is so enable to personate or represent him in dealings with the world at large. The main purpose of Trusteeship is to protect the rights and interest of persons who for any reason are unable effectively to protect them for themselves. Such protection is required for four classes of people. (a) unborn persons; (b) infants, lunatics, or other disqualified persons; (c) a large number of persons who are interested in common and (d) persons having conflicting interest in the same property, i.e., an owner and an encumbrance or different kinds of encumbrances. Therefore, the first requirement of holding of shares both as a legal registered owner and beneficial owner of such shares was not satisfied in the case of the assessee. Therefore, provisions of section 2(22)(e) would not be applicable at all to the case of the assessee. [Para 27]

The provisions of section 2(22)(e) which brought in a new category of payment which was to be considered as dividend as introduced by the Finance Act, 1987 with effect from 1-4-1988, viz., payment by a company 'to any concern in which such shareholder is a member or a partner and in which he has a substantial interest' *do not say as to in whose hands the dividend has to be brought to tax, whether in the hands of the 'concern' or the 'shareholder'*. [Para 30]

The intention behind enacting provisions of section 2(22)(e) are that closely held companies (i.e., companies in which public are not substantially interested), which are controlled by a group of members, even though the company has accumulated profits would not distribute such profit as dividend because if so distributed the dividend income would become taxable in the hands of the shareholders. Instead of distributing accumulated profits as dividend, companies distribute them as loan or advances to shareholders or to concern in which such shareholders have substantial interest or make any payment on behalf of or for the individual benefit of such shareholder. In such an event, by the deeming provisions such payment by the company is treated as dividend. The intention behind the provisions of section 2(22)(e) is to tax dividend in the hands of shareholder. The deeming provisions as it applies to the case of loans or advances by a company

to a concern in which its shareholder has substantial interest, is based on the presumption that the loan or advances would ultimately be made available to the shareholders of the company giving the loan or advance. Therefore the intention of the legislature is, to tax dividend only in the hands of the shareholder and not in the hands of the concern. [Para 35]

The basis of bringing in the amendment to section 2(22)(e) by the Finance Act, 1987 with effect from 1-4-1988 is to ensure that persons who control the affairs of a company as well as that of a firm can have the payment made to a concern from the company and the person who can control the affairs of the concern can draw the same from the concern instead of the company directly making payment to the shareholder as dividend. The source of power to control the affairs of the company and the concern is the basis on which these provisions have been made. It is, therefore, proper to construe those provisions as contemplating a charge to tax in the hands of the shareholder and not in the hands of a non-shareholder, viz., concern. A loan or advance received by a concern is not in the nature of income. In other words, there is a deemed accrual of income even under section 5(1)(b) in the hands of the shareholder only and not in the hands of the payee, viz., non-shareholder (Concern). Section 5(1)(a) contemplates that the receipt or deemed receipt should be in the nature of income. Therefore, the deeming fiction can be applied only in the hands of the shareholder and not the non-shareholder, viz., the concern. [Para 36]

The definition of dividend under section 2(22)(e) is an inclusive definition. Such inclusive definition enlarges the meaning of the term 'Dividend' according to its ordinary and natural meaning to include even a loan or advance. Any loan or advance cannot be dividend according to its ordinary and natural meaning. The ordinary and natural meaning of the term dividend would be a share in profits to an investor in the share capital of a limited company. To the extent the meaning of the word 'Dividend' is extended to loans and advances to a shareholder or to a concern in which a shareholder is substantially interested deeming them as dividend in the hands of a shareholder the ordinary and natural meaning of the word 'Dividend' is altered. To this extent the definition of the term 'Dividend' can be said to operate. If the definition of 'Dividend' is extended to a loan or advance to a non-shareholder, the ordinary and natural meaning of the word 'dividend' is taken away. In the light of the intention behind the provisions of section 2(22)(e) and in the absence of indication in section 2(22)(e) to extend the legal fiction to a case of loan or advance to a non-shareholder also, the loan or advance to a non-shareholder cannot be taxed as deemed dividend in the hands of a non-shareholder. [Para 37]

The basic characteristic of dividend is a share of profits of the company given to its shareholders. Further, section 206 of the Companies Act, 1956 prohibits payment of dividend to any person other than the registered shareholder. If one was to break up the natural meaning the following components emerge (a) dividend is a share of profits of the company (b) paid to its shareholders. section 2(22) artificially extends the scope of dividend from being more than only a distribution of profits to cover certain other types of disbursements such as loans paid etc. (the first ingredient mentioned above). It [section 2(22)] does not, however, alter the second component of its natural meaning, viz., paid to its shareholder. In other words all that section 2(22) seeks to do is to expand the various types of payments that may be regarded as dividend.

The contention of the revenue that provisions of section 8(a) created a fiction by which even payments to non shareholders could be construed as dividend could not be accepted. Those provisions merely fix the year in which dividend has to be taxed. It is, therefore, clear that the shareholder alone can, if at all, be subjected to tax for having earned dividend. [Para 38]

Further, in the event of the payment of loan or advance by a company to a concern being treated as dividend and taxed in the hands of the concern then, the benefit of set off cannot be allowed to the concern, because the concern can never receive dividend from the company which is only paid to the shareholder, who has substantial interest in the concern. The above provisions also, therefore, contemplate deemed dividend being taxed in the hands of a shareholder only. [Para 40]

In view of aforesaid, it was opined that deemed dividend can be assessed only in the hands of a person who is a shareholder of the lender company and not in the hands of a person other than a shareholder. Further, the expression shareholder referred to in section 2(22)(e) refers to both a registered shareholder and beneficial shareholder. If a person is a registered shareholder but not the beneficial shareholder then the provisions of section 2(22)(e) would not apply. Similarly, if a person is a beneficial shareholder but not a registered shareholder then also the provisions of section 2(22)(e) would not apply. [Para 41]

In view of aforesaid, there was no merit in appeal filed by the revenue and, therefore, same was to be dismissed. [Para 42]

#### CASE REVIEW

Dy. CIT v. Nikko Technologies (I) (P.) Ltd. [IT Appeal No. 4077 (Mum) of 2002, dated 30-12-2005] [Para 40] dissented from; CIT v. C.P. Sarathy Mudaliar [1972] 83 ITR 170 (SC) [Para 22] ; Rameshwarlal Sanwormal v. CIT [1980] 122 ITR 1 / 3 Taxman 1 (AP) [Para 22] and CIT v. Hotel Hill Top [IT Appeal No. 25 (Raj.) of 2005, dated 17-3-2008] [Para 31] followed.