IN THE HIGH COURT OF KARNATAKA AT BANGALORE

DATED THIS THE 8th DAY OF JANUARY 2014

PRESENT

THE HON'BLE MR. JUSTICE DILIP B BHOSALE

AND

THE HON'BLE MR. JUSTICE B MANOHAR

ITA.NO.322/2012 C/W ITA.NOS.323/2012 & 324/2012

BETWEEN

1. THE CHIEF COMMISSIONER
OF INCOME TAX-III
CENTRAL REVENUE BUILDINGS
QUEENS ROAD, BANGALORE-560 001

2. THE ASSISTANT COMMISSIONER OF INCOME TAX
CENTRAL CIRCLE 1(2)
C R BUILDINGS, BANGALORE ... COMMON APPELLANTS

(BY SRI E R INDRAKUMAR, SENIOR COUNSEL FOR
E I SANMATHI, ADV.,)

AND

M/S SARVA EQUITY PVT LTD
NO.380, OPP. TO CPWD QUARTERS
3RD BLOCK, KORAMANGALA
BANGALORE-560034 ... COMMON RESPONDENT

(BY SRI A SHANKAR & SRI M LAVA, ADVS)

ITA.NO.322/2012 FILED UNDER SEC.260-A OF I.T. ACT, 1961, ARISING OUT OF ORDER DATED 13/04/2012 PASSED IN ITA NO.762/BANG/2011, FOR THE ASSESSMENT YEAR 2006-07, PRAYING TO: I. FORMULATE THE SUBSTANTIAL QUESTION OF LAW STATED THEREIN, II. SET ASIDE THE COMMON APPELLATE ORDER DATED 13/04/2012 PASSED BY THE ITAT, 'A' BENCH, BANGALORE, IN APPEAL PROCEEDINGS ITA NO.762/BANG/2011, AS SOUGHT FOR IN THIS APPEAL.

ITA NO.323/2012 FILED UNDER SEC.260-A OF I.T. ACT, 1961, ARISING OUT OF ORDER DATED 13/04/2012 PASSED IN ITA NO.763/BANG/2011, FOR THE ASSESSMENT YEAR 2007-08, PRAYING TO: I. FORMULATE THE SUBSTANTIAL QUESTION OF LAW STATED THEREIN, II. SET ASIDE THE COMMON APPELLATE ORDER DATED 13/04/2012 PASSED BY THE ITAT, 'A' BENCH, BANGALORE, INAPPEAL PROCEEDINGS NO.ITA NO.763/BANG/2011, AS SOUGHT FOR IN THIS APPEAL.

ITA NO.324/2012 FILED UNDER SEC.260-A OF I.T. ACT, 1961, ARISING OUT OF ORDER DATED 13/04/2012 PASSED IN ITA NO.764/BANG/2011, FOR THE ASSESSMENT YEAR 2008-2009, PRAYING TO: I. FORMULATE THE SUBSTANTIAL QUESTION OF LAW STATED THEREIN, II. SET ASIDE THE COMMON APPELLATE ORDER DATED 13/04/2012 PASSED BY THE ITAT, 'A' BENCH, BANGALORE, IN APPEAL PROCEEIDNGS ITA NO.764/BANG/2011.

THESE ITA's COMING ON FOR ORDERS, THIS DAY, DELIVERED THE FOLLOWING:

ORAL JUDGMENT: ***(DILIP B. BHOSALE J.)***

These income tax appeals preferred by the revenue are against the order dated 13th April 2012 passed by the Income Tax Appellate Tribunal, 'A' Bench, Bangalore (for short "**Tribunal**") in ITA Nos.762-764/Bang/2011 pertaining to assessment years 2006-07 to 2008-09. Tribunal vide order dated 13th April 2012 dismissed the appeals answering the questions formulated therein in favour of the assessee. The questions formulated by the Tribunal read thus:

> "1. Whether the CIT(A) was correct in law in interpreting the provisions 2(22)(e) of the IT Act by holding that the amount cannot be assessed as deemed dividend in the hands of the assessee?
>
> 2. Whether on the facts and circumstances of the case, the CIT(A) erred in law in interpreting section 2(22)(e) of the IT Act which was introduced to forestall the manipulation of likelihood of closely held companies not distributing their profits by way of dividends but by way of loans and advances to escape tax?
>
> 3. In view of the ground No.2 above, whether the CIT(A) is correct in holding that deemed dividend that arose under section

2(22)(e) of the IT Act should be taxed in the hands of the shareholder only and not in the hands of the concern as per Board/s Circular No.495 dated 22.09.87?"

2. The appeals before the Tribunal were directed against the order dated 10-6-2011 passed by the Commissioner of Income Tax (Appeals), Mysore in ITA Nos.4-42/443/668/CIT (A-VI)/Bangalore, (for short "**the first Appellate Authority**") by which the appeals filed by the respondent-assessee were allowed with a direction to the Assessing Officer to examine the liability of the shareholders in respect of deemed dividend as per law. The Assessing Officer vide order dated 31-12-2009, held that the amount of Rs.9,56,48,027/- is the deemed income of the respondent-assessee as contemplated under Section 2(22)(e) of the Income Tax Act, 1961 (for short "**the Act**").

3. Briefly stated, the facts leading to these appeals are that the respondent-assessee and one M/s.Ittina Group of Companies are sister concern. Search under Section 132

of the Act was conducted on 28-2-2008 on the premises M/s.Ittina Properties Private Limited (for short "**Ittina**") and in the course of search certain incriminating documents relating to the respondent-assessee were seized. The Assessing Officer, therefore, issued notice under Section 153C of the Act on 24-9-2009 obliging the respondent-assessee to file return of income within 15 days from the date of receipt of the notice. The assessee replied the notice vide letter dated 13-10-2009 informing the Assessing Officer that E-returns were filed by them on 30-11-2006 declaring loss of Rs.1,35,293/-. In view thereof, notices under Sections 142 and 143(2) were issued on 20-10-2009 and the assessment was done in which it was revealed that the respondent assessee had taken an unsecured loan from Ittina of Rs.9,56,48,107/-. He accordingly treated that as a deemed dividend under Section 2(22)(e) and directed the respondent-assessee to pay tax of Rs.4,66,16,860/- including interest. The order of the Assessing Officer was carried by the respondent-assessee in appeal before the Appellate Authority. The

Appellate Authority reversed the order passed by the Assessing Officer holding that the respondent-assessee is not a shareholder of M/s.Ittina Properties Private Limited and in view thereof, not liable to pay taxes under Section 2(22)(e) of the Act. The order of the appellate authority has been confirmed by the Tribunal vide the order, impugned in the present appeals.

4. We have heard learned counsel for the parties and with their consent the appeals were taken up for final disposal at the stage of admission, on the substantial questions of law formulated by us with the assistance of learned counsel for the parties.

5 Though the revenue has formulated the substantial questions of law in the memorandum of the appeal, learned counsel for the parties have agreed that the substantial question of law that falls for our consideration is whether, on the facts and in the circumstances of the case, the Assessing Officer in law, was justified in treating the advance/loan paid to the

assessee of Rs.9,56,48,107/- as deemed dividend under Section 2(22)(e) of the Act and that the advance/loan paid to the respondent-assessee, who was and is not a shareholder of M/s.Ittina Properties (P) Limited, is covered by the word "dividend" as contained in Section 2(22)(e) of the Act? It is made clear that the question was formulated by us even before commencement of the arguments and then the learned counsel for the parties, by consent, were heard for final disposal at the stage of admission.

6. The questions that arise in these appeals for our consideration are against the fact that Rs.9,56,48,027/-, Rs.9,34,849/- and Rs.8,385/- for the assessment years 2006-07 to 2007-08 respectively were advanced by M/s.Ittina to the respondent-assessee, as contended by the revenue and therefore, liable to be taxed being deemed dividend under Section 2(22)(e) of the Act. The respondent-assessee has disputed payment/advancement of these amounts as dividend and according to them, these

amounts were paid as advance by M/s.Ittina to the respondent-assessee as routine business transactions. What we propose to examine is whether these amounts, paid by M/s.Ittina, as loan/advance to the respondent-assessee, could be treated as deemed dividend.

7. Mr.E.S.Indra Kumar, learned Senior Advocate appearing for the appellant-revenue at the outset submitted that one Sri I.Mahabaleshwarappa and his family members were directors and shareholders of M/s. M/s.Ittina so also of the respondent-assessee and they were having substantial share holding in both the companies. In view thereof, he submitted that though the respondent-assessee was not a shareholder of M/s.Ittina still it is liable to be held as shareholder within the meaning of Section 2(22)(e) of the Act and liable to be taxed as contemplated under the second limb of Section 2(22)(e) of the Act. In support of his contention, he placed reliance upon the Circular dated 22nd September 1987 bearing Circular No.495.

8. On the other hand, Mr.A.Shankar, learned counsel appearing for the respondent-assessee invited our attention to the judgments of the Bombay High Court in ***CIT Vs. Universal Medicare Private Limited,*** **[2010] 324 ITR 263 (Bom.),** the judgment of Delhi High Court in ***Commissioner of Income Tax vs. MCC Marketing Private Limited,*** **[2012] 343 ITR 350 (Delhi)** and in ***C.I.T. vs. Ankitech P. Ltd.*** **[2012] 340 ITR 14 (Delhi)** to contend that since the respondent-assessee was and is not a shareholder of M/s.Ittina from which it has received monies, which are in the nature of loan or advances, are not covered by the definition of the word "dividend" as contained in Section 2(22)(e) of the Act.

9. There does not appear to be any dispute that the amounts, as aforementioned, were advanced by M/s.Ittina to the respondent-assessee during the relevant assessment years. Admittedly, the respondent-assessee was not a shareholder of M/s.Ittina at any point of time. It is true that the Directors and share holders of both the

companies, are members of one and the same family and they have substantial holding in M/s.Ittina and respondent-company. Whether that by itself, is sufficient to treat the amounts advanced as deemed dividend within the meaning of Section 2(22)(e) of the Act is the question that falls for our consideration.

10. The Bombay High Court in *Universal Medicare Private Limited (supra)* was dealing with some what similar situation. The questions framed by the Bombay High Court in *Universal Medicare* read thus:

> "1. Whether, on the facts and in the circumstances of the case, the Income-tax Appellate Tribunal, in law, was right in deleting the addition of Rs.35 lakhs treated as deemed dividend under section 2(22)(e) of the Income-tax Act, 1961, by stating that since the transactions are not reflected in the books of account, it cannot be treated as deemed dividend?
>
> 2. Whether, on the facts and in the circumstances of the case, the Tribunal in law, was right in holding that the Assessing Officer has not established that the money was advanced for the benefit of any shareholder and the same has to be taxed in the hands of such shareholder who obtained the benefit and not in the hands of the assessee-company,

following the ratio of the decision in the case of Asst. CIT v. Bhaumik Colour P. Limited(2009) 313 ITR (AT) 146 (Mumbai); 27 SOT 270 (SB)?"

10.1. While dealing with this question the Bombay High Court after considering the scheme of Section 2(22)(e) of the Act observed thus:

> "However, even on the second aspect which has weighed with the Tribunal, we are of the view that the construction which has been placed on the provisions of section 2(22)(e) is correct. Section 2(22)(e) defines the ambit of the expression "dividend". All payments by way of dividend have to be taxed in the hands of the recipient of the dividend namely the shareholder. The effect of section 2(22) is to provide an inclusive definition of the expression "dividend". Clause(e) expands the nature of payments which can be classified as a dividend. Clause(e) of section 2(22) includes a payment made by the company in which the public are not substantially interested by way of an advance or loan to a shareholder or to any concern of which such shareholder is a member or partner, subject to the fulfillment of the requirements which are spelt out in the provision. Similarly, a payment made by a company on behalf, or for the individual benefit, of any such shareholder is treated by clause (e) to be included in the expression "dividend". Consequently, the effect of clause (e) of section 2(22) is to broaden the ambit of the expression "dividend" by including certain payments which the company has

made by way of a loan or advance or payments made on behalf of or for the individual benefit of a shareholder. The definition does not alter the legal position that dividend has to be taxed in the hands of the shareholder. Consequently in the present case the payment, **even assuming that it was a dividend, would have to be taxed not in the hands of the assessee but in the hands of the shareholder. The Tribunal was, in the circumstances, justified in coming to the conclusion that, in any event, the payment could not be taxed in the hands of the assessee.** We may in concluding note that the basis on which the assessee is sought to be taxed in the present case in respect of the amount of Rs.32,00,000/- is that there was a dividend under section 2(22)(e) and no other basis has been suggested in the order of the Assessing Officer."

(emphasis supplied)

11. The Delhi High Court in *MCC Marketing Pvt. Ltd. (supra)* also considered almost similar questions and in the light of the judgment of the Division Bench of the very High Court in *CIT Vs. Ankitech P. Ltd*. held that the Assessing Officer erred in invoking the provisions of Section 2(22)(e) of the Act mainly because the Director of the Company was holding more than 20% shares in both the donor and donee companies. It would be

advantageous to reproduce the observations made by the Division Bench of the Delhi High Court in *Ankitech P. Ltd. (supra)* which read thus:

> "The intention behind enacting the provisions of section 2(22)(e) is 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) of the Act is to tax dividend in the hands of shareholders. **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 loans or advances would ultimately be made available to the shareholders of the company giving the loan or advance.**
>
> Further**, it is an admitted case that under normal circumstances, such a loan or advance given to the shareholders or to**

a concern, would not qualify as dividend. It has been made so by legal fiction created under section 2(22)(e) of the Act. We have to keep in mind that this legal provision relates to 'dividend'. Thus, by a deeming provision, it is the definition of dividend which is enlarged. Legal fiction does not extend to 'shareholder'. When we keep in mind this aspect, the conclusion would be obvious, viz., loan or advance given under the conditions specified under section 2(22)(e) of the Act would also be treated as dividend. **The fiction has to stop here and is not to be extended further for broadening the concept of shareholders by way of legal fiction. It is a common case that any company is supposed to distribute the profits in the form of dividend to its shareholders/members and such dividend cannot be given to non-members. The second category specified under section 2(22)(e) of the Act, viz., a concern (like the assessee herein), which is given the loan or advance is admittedly not a shareholder/member of the payer company. Therefore, under no circumstance, it could be treated as shareholder/member receiving dividend. If the intention of the Legislature was to tax such loan or advance as deemed dividend at the hands of 'deeming shareholder', then the Legislature would have inserted deeming provision in respect of shareholder as well, that has not happened.** Most of the arguments of the learned counsel for the Revenue would stand answered, once we look into the matter from this perspective."

(emphasis supplied)

11.1 Further, we would like to quote the following observations made in paragraphs-27 and 28 from the Judgment of the Delhi High Court in *Ankitech P. Ltd. (supra),* which read thus:

> "……The courts have held that if the amounts advanced are for business transactions between the parties, such payment would not fall within the deeming dividend under Section 2(22)(e) of the Act.
>
> In so far as reliance upon Circular No.495, dated September 22, 1987, issued by the Central Board of Direct Taxes is concerned, we are inclined to agree with the observations of the Mumbai Bench decision in Bhaumik Colour (P) Ltd. [2009] 313 ITR (AT) 146 (Mumbai) [SB] that such observations are not binding on the Courts. Once it is found that such loan or advance cannot be treated as deemed dividend at the hands of such a concem which is not a shareholder, and that, according to us, is the correct legal position, such a circular would be of no avail."

11.2. Our attention was also invited to another judgment of the Supreme Court in ***Keshavji Ravji and Co., -vs- Commissioner of Income-Tax*** **(1990) 183 ITR 1**. The relevant observations in the said judgment read thus:

> "The Tribunal, much less the High Court, is an authority under the Act. The circulars do not bind them. But the benefits of such circulars to assessees have been held to be permissible even though the circulars might have departed from the strict tenor of the statutory provision and mitigated the rigour of the law. But that is not the same thing as saying that such circulars would either have a binding effect in the interpretation of the provision itself or that the Tribunal and the High Court are supposed to interpret the law in the light of the circular."

12. The Delhi High Court in *National Travel Services (supra)* though was considering the provisions of Section 2(22)(e) of the Act, what fell for its consideration was whether the assessee-firm could be treated as a shareholder having purchased shares through its partners in the company which had paid the loans or was it necessary that the shareholder had to be a registered shareholder. After considering the relevant provisions and several judgments, the Delhi High Court in paragraph 19 observed thus:

> ".....Whether the assessee firm can be treated as a shareholder having purchased shares through its partners in the company which has paid the loans or is it necessary that

> a shareholder has to be a 'registered shareholder'. If the contention of the assessee is accepted, in no case a partnership firm can come within the mischief of Section 2(22)(e) of the Act because of the reason that shares would be purchased by the firm in the name of its partners as the firm is not having any separate entity of its own. With the name of the partner entering into the register of members of the company as shareholder, the said partner shall be the 'shareholder' in the records of the company but not the beneficial owner as 'beneficial owner' is the partnership firm. This would mean that the loan or advance given by the company would never be treated as deemed dividend either in the hands of the partners or in the hands of partnership firm. In this way the very purpose for which this provision was enacted would get defeated. The object behind this provision is succinctly stated in the Circular No.495 of 22nd September, 1987 particularly in the Explanatory Notes to Finance Act, 1987 when this provision was amended."

12.1. The question that the Delhi High Court was considering in the said judgment read thus:

> "(1) To attract the first limb of Section 2(22)(e) of the Act, is it necessary that the person who has received the advance or loan is a shareholder and also beneficial owner. To put it otherwise, whether both the conditions are required to be satisfied will depend upon the interpretation to be given to the words "being a person who is a beneficial owner of shares…" which was inserted by amendment

in the aforesaid provision carried out by the Finance Act, 1987 w.e.f. 1st April, 1988.

(2) Whether the assessee who is a partnership firm can be treated as 'shareholder' because of the reason that it has purchased the shares in the name of the two partners."

13. It would be relevant to look into the provisions contained in Section 2(22)(e) of the Act, which reads thus:

"Dividend" includes .....

"(e) 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."

14. As observed by the Bombay High Court in Universal Medicare, Clause(e) of Section 22 is not

artistically worded. This clause can be divided into three parts/has three limbs, as follows:

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 31st May 1987 by way of advance or loan: i) 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 percent of the voting power, ii) or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereinafter in this clause referred to as the said concern); and iii) 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.

15. The remaining part of provision is not material for the purpose of this appeal. By providing an inclusive

definition of the expression "dividend", Clause (e) of Section 2(22) of the Act brings within its purview attempts which may not ordinarily constitute the payment of dividend. Parliament has expanded the ambit of the expression "dividend" by providing an inclusive definition.

16. In the present case, we are concerned with the second limb of Section 2(22)(e) of the Act namely, to any concern, like the respondent-assessee, in which such shareholder is a member or a partner and in which he has a substantial interest. The respondent asseessee is admittedly not a shareholder of M/s.Ittina. It is not even the case of the assessee that it is a shareholder of M/s.Ittina, though, shareholders of the respondent-assessee and M/s.Ittina are common and/or members of the same family. In this backdrop when we look at the provisions contained in Section 2(22)(e) of the Act, the intendment of the Legislature is clear, which means to tax dividend in the hands of shareholders. The deeming provisions, as observed by Delhi High Court, as it applies

to the case of loans/advances by a Company to a concern in which its shareholders have substantial interest, is based on the presumption that the loans or advances would ultimately be made available to the shareholders of the Company giving the loan or advances. Loan or advance given to the shareholders or to a concern, under normal circumstances would not qualify as dividend, but it is so made by legal fiction created under Section 2(22)(e) of the Act. Thus, the definition of dividend has been enlarged, and that loan or advances given under the conditions specified under this provision would also be treated as dividend. The fiction, however, is not to be extended for enlarging the concept of shareholders. Dividend is to be given by any company, to its shareholders. Thus, in the second category under Section 2(22)(e) of the Act, loan or advances given to a concern, like the assessee in the present case, which is admittedly not a shareholder of the payee company, under no circumstances, could be treated as shareholder receiving dividend. As observed by Delhi High Court, if the intention of the Legislature was to tax

such loan or advance as deemed dividend at the hands of deeming shareholder, then the legislature would have inserted deeming provision in respect of shareholder as well. The legislature has not done so.

17. Section 2(22)(e) of the Act is designed to strike balance, i.e., advance or loan to a shareholder and that the word shareholder can mean only a registered shareholder. A beneficial owner of shares whose name does not appear in the Register of shareholders of the Company cannot be stated to be a shareholder. He may be beneficially entitled to the share but he is certainly not a shareholder. In other words, it is only the person whose name is entered in the Register of the shareholders of the Company as the holder of the shares who can be said to be a shareholder qua Company and not the person beneficially entitled to the shares. We are therefore, of the view that it is only where a loan is advanced by the Company to the registered shareholder and the other conditions set out in Section 2(22)(e) of the Act are

satisfied, that amount of loan would be liable to be regarded as deemed dividend within the meaning of this section.

18. We do not find any reason to take a view other than the one taken by the Delhi and Bombay High Courts in the aforementioned judgments nor could the Senior counsel appearing for the revenue persuaded us to take differing view. In the circumstances, we find no reason to interfere with the concurrent finding of facts recorded by the two authorities below namely the Appellate Authority and the Tribunal. In the circumstances, we answer the question as formulated by us in favour of the respondent-assessee and against the revenue.

19. Before we part, we observe that it is always open to the revenue to take corrective measure, if any, by treating this as deemed income at the hands of the shareholders by following the due procedure as contemplated by law and in accordance with law. We are

so observing, because otherwise it would amount to escapement of income at the hands of those shareholders.

The appeals are accordingly disposed of.

Sd/-
JUDGE

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