+* **THE HIGH COURT OF DELHI AT NEW DELHI**

% Judgment delivered on : 14.05.2009

+ **ITA No 1130/2007**

COMMISSIONER OF INCOME TAX ..... Appellant

versus

SHRI RAJ KUMAR ..... Respondent

Advocates who appeared in this case:

For the Appellant : Ms Prem Lata Bansal, Sr. Standing Counsel with Mr M.P. Gupta, Mr Sanjeev Rajpal & Ms Anshul Sharma, Advocate

For the Respondent : Mr S.K. Khurana, Advocate

CORAM :-

HON'BLE MR JUSTICE VIKRAMAJIT SEN
HON'BLE MR JUSTICE RAJIV SHAKDHER

1. Whether the Reporters of local papers may be allowed to see the judgment ? Yes
2. To be referred to Reporters or not ?
3. Whether the judgment should be reported in the Digest ? Yes

RAJIV SHAKDHER, J

1. This is an appeal preferred by the Revenue under Section 260A of the Income Tax Act, 1961 (hereinafter referred to as the 'Act') against the judgment dated 09.03.2007 passed by the Income Tax Appellate Tribunal (hereinafter referred to as the 'Tribunal') in ITA No. 4125/Del/1999 in respect of assessment year 1996-97. The Revenue is aggrieved by virtue of the fact that by the impugned judgment the Tribunal has deleted an addition in the sum of

Rs 12,28,517/- made by the Assessing Officer under Section 2(22)(e) of the Act.

2. At the time of admission of the appeal we had heard the matter extensively. By our order dated 22.04.2009 we admitted the appeal on the substantial question of law set out hereinbelow and had with the consent of counsel appearing for both parties heard the submissions with a view to finally adjudicate upon the same. The substantial question of law on which the appeal was admitted is as follows:-

> "*Whether trade advances given to the assessee by CEI can be treated as deemed dividend under Section 2(22)(e) of the Income Tax Act, 1961?"*

3. For the purposes of adjudication of the appeal the following relevant facts require to be noted.

3.1 The assessee who is a proprietor of a concern by the name of M/s Premier Engineering Corporation is in the business of manufacturing customized kitchen equipment. The assessee is also the Managing Director and holds nearly 65% of the paid-up share capital of Continental Equipment India (Pvt.) Ltd. (in short 'CEI').

3.2 A substantial part of the business of the assessee, which is nearly 90%, is obtained through CEI. For this purpose CEI would pass on the advance received from its customers to the assessee to execute the job work entrusted to the assessee.

3.3 During the scrutiny of the return of the assessee for the assessment year in issue, the Assessing Officer on going through the balance sheet filed by the assessee along with the return discovered that the assessee owed a sum of Rs 14,59,770/- to CEI. Admittedly, this amount was shown by the assessee under the head "advances received from customers". The assessee was queried with respect to the nature of the receipt. In response thereto the assessee offered the following explanation that: nearly 90% of his sales was to CEI; its closing stock for the accounting period 31.03.1996 was equivalent to Rs 18,43,927/- which formed part of the sales made in the subsequent year to CEI; the advances received and shown under the head "advances received from customers" were trade advances received against future supplies which was backed by sales made immediately upon manufacture of the goods in issue; the advances received were not returned by cheque or otherwise; and in any event, Section 2(22)(e) of the Act did not bring within its ambit advances received against future supply of goods. In support of the last submission assessee placed reliance on the judgment of the Bombay High Court in the case of ***CIT vs Nagindas M. Kapadia (1989) 177 ITR 393***. The assessee also tried to distinguish the judgment of the Supreme Court with which he was confronted, that is, in the case of ***Miss P. Sarada vs CIT (1998) 229 ITR 444***.

3.4 The Assessing Officer however, was not convinced that the money received by the assessee was in the nature of an advance received by CEI from its customers which was passed on to the assessee towards execution of the job work entrusted to him for manufacture of customized kitchen equipment. The Assessing Officer was of the opinion that the money received by the assessee was in the nature of a loan given by CEI to the assessee who admittedly held more than 10% of the shares in CEI. Resultantly, the Assessing Officer concluded that the money received by the assessee was deemed dividend within the meaning of the provisions of Section 2(22)(e) of the Act. In view of the fact that the accumulated profits of CEI as on 31.03.1996 was a sum of Rs 12,28,517/- the addition was restricted to the said amount.

3.5 In coming to the conclusion which the Assessing Officer did, he distinguished the judgment of the Bombay High Court in ***Nagindas M. Kapadia*** *(supra)* by relying upon the following observations made on page 393 of the report:

> *"Held that only the payments and advances to the extent of accumulated profits could be treated as loans or advance within the meaning of Section 2(22)(e) and this was what the Tribunal had done."*

3.6 Furthermore, the Assessing Officer placed reliance on the judgment of the Supreme Court in ***P. Sarada*** *(supra)* and observed that the legal fiction had got triggered as soon as the assessee received

dividend, irrespective of the fact whether or not that there was an ultimate adjustment or repayment, as it would not alter the fact that the assessee had received dividend from CEI during the accounting period. In coming to this conclusion the Assessing Officer also took into account the communication received from CEI with respect to confirmation of balance as on 31.03.1996 which indicated that the assessee had received a sum of Rs 8,35,000/- out of a total of Rs 14,59,770/- in the form of interest free loan. Based on this communication the Assessing Officer noted that the said amount i.e., Rs 8,35,000/- was received by the assessee from CEI on the following dates:-

Date on which loan given	Amount
14.02.1996	2,50,000/-
16.02.1996	5,00,000/-
16.02.1996	35,000/-
17.02.1996	50,000/-

3.7 The Assessing Officer also went on to hold, based on the copy of the bank account maintained by the assessee, that the assessee had spent the amount received as loan from CEI as well as from other parties, towards acquisition of land and building from DSIDC.

3.8 The Assessing Officer thus, as stated hereinabove, concluded that the money received by the assessee from CEI was in the nature of deemed dividend under the provisions of Section 2(22)(e) of the Act.

4. The assessee being aggrieved preferred an appeal before the Commissioner of Income Tax (Appeals) [hereinafter referred to as 'CIT(A)']. The CIT(A) after examining the matter in great detail reversed the order of the Assessing Officer. The CIT(A) while doing so returned the following findings of fact:

(i) The kitchen equipment manufactured by the assessee was invariably of a specific design and specification which require considerable period of time for manufacture;

(ii) There was nothing on record to show that the loan advanced by CEI to the assessee was made out of the accumulated profits of CEI nor was the advance in any manner related to or connected with the accumulated profits of CEI;

(iii) After perusing the details of advance received by CEI from its customers, a substantial part of which was transmitted to the assessee, he concluded that the amount remained outstanding in the books of the assessee at the close of the year was not in the nature of a loan or advance in terms of Section 2(22)(e) of the Act.

(iv) The money received from CEI by the assessee was neither a loan nor advance in terms of provision of Section 2(22)(e) of the Act.

4.1 We must point out at this stage that the CIT(A) examined in detail the explanation given by the assessee that the balance confirmation communication issued by CEI with respect to the sum of

Rs 8,35,000/- was an inadvertent mistake committed by the accountant of CEI while confirming the balance of loan amount due with regard to other parties. The CIT(A) also noted the contention of the assessee that the amount in issue was correctly reflected in the audited balance sheet as advance received against supply of goods as on 31.03.1996 and also the fact that the said balance sheet had been filed along with the return of income on 25.02.1997; coupled with the fact that the assessee had clarified the same in his letter dated 25.09.1998.

4.2 The CIT(A) on arriving at a finding of fact, with respect to the nature of advance, applied the judgment of the Bombay High Court in the case of ***Nagindas M. Kapadia*** *(supra)* and came to the conclusion that amounts received with respect to purchase of material could not be brought within the ambit of Section 2(22)(e) of the Act. The relevant portion of the judgment on which reliance was placed being apposite is extracted below:-

> *"The Tribunal has, on going through the details of the account, found that payments other than the payment of Rs 28,500 in the assessment year 1968-69 and other than Rs 10,000 in the assessment year 1969-70 were made as advances towards the purchases to be made by the company from the assessee. Accordingly, the Tribunal held that only the sum of Rs 28,500 in the assessment year 1968-69 and Rs 10,000 in the assessment year 1969-70 represented payments or advances within the meaning of section 2(22)e) of the Income-tax Act and could be treated as deemed dividend income."*

4.3 Accordingly, the CIT(A) deleted the addition of Rs 12,28,517/-.

5. The Revenue being aggrieved preferred an appeal to the Tribunal. The Tribunal after examining the record and upon considering the submissions made by both sides sustained the decision of the CIT(A).

5.1. In coming to the said conclusion the Tribunal returned the following findings of fact:

(i) In respect of sum of Rs 8,35,000/- the Tribunal came to the conclusion, after considering the explanation given by the assessee, which according to it stood corroborated by the surrounding circumstances, that it was satisfied that the said sum was not in the nature of a loan. It took into account the fact that even though the sum of Rs 8,35,000/- had been received by the assessee on various dates and had been credited to the Savings Bank account from which cheques were issued to DSIDC for acquisition of land and building, the said amount was credited to CEI's account maintained in the assessee's book, in one lump sum on 19.12.1996. The fact that it did not bear interest and that it was adjusted against bills submitted by the assessee as was evident from the ledger maintained by the assessee, propelled it to conclude that the said sum was not in the nature of a loan.

(ii) It also found that, out of a sum of Rs 17,60,492/- which was shown as advance received from customers in the assessee's balance sheet for the period ending on 31.03.1996 Rs 14,59,769/- was due to CEI. In the said balance sheet the assessee had shown the closing stock

at Rs 18,43,927/- out of which the assessee sold stock worth Rs 17,70,170/- between April and August 1996 to CEI. In other words 96% of the closing stock was sold to CEI. From this it was concluded by the Tribunal that the money received by the assessee from CEI was used to manufacture kitchen equipment supplied by the assessee to CEI. Accordingly, the Tribunal concluded that the amount in issue could not be treated as a loan or advance in terms of Section 2(22)(e) of the Act as there was no obligation to repay the said sum with or without interest. The Tribunal agreed with the submissions of the assessee that the judgment of the Bombay High Court in ***Nagindas M. Kapadia*** *(supra)* was applicable in the facts of the case as also that the judgments of the Supreme Court in ***P. Sarada*** *(surpa)* and ***Smt. Tarulata Shyam vs CIT (1977) 108 ITR 345*** did not deal with the question in issue.

6. Before us the learned counsel for Revenue Ms Prem Lata Bansal and that for the assessee Mr S.K. Khurana advocated their respective cases with great felicity. It was the submission of Ms Prem Lata Bansal on behalf of the Revenue that the ambit of Section 2(22)(e) of the Act was wide as it took within its fold any payment which was received by a shareholder from a company in which public are not substantially interested and in which he holds more than 10% of the shares. The learned counsel for the Revenue placed reliance on the order of the Assessing Officer to contend that a substantial amount out

of the said sum, that is, Rs 8,35,000/- was not received by the assessee to give effect to a commercial transaction. She further contended that the judgment of the Bombay High Court i.e., ***Nagindas M. Kapadia*** *(supra)* was not in favour of the assessee; as a matter of fact, if at all, the ratio of the judgment supported the stand of the Revenue. It was the learned counsel's submission that, in any event, even if the finding of the CIT(A) and the Tribunal is accepted to be correct trade advances would also fall within the ambit of Section 2(22)(e) of the Act.

7. As against this the learned counsel for the assessee placed great reliance on the findings and the observation of both the CIT(A) and the Tribunal. It was contended by the learned counsel that in so far as the nature of the payment is concerned there is a finding of fact in his favour that it was in the nature of an advance received to purchase material for the purposes of executing the job work entrusted to the assessee. He placed reliance on the judgment of the Bombay High Court in ***Nagindas M. Kapadia*** *(supra)* to contend that such amounts did not fall within the ambit of Section 2(22)(e) of the Act. As regards the judgment of the Supreme Court in the case of ***P. Sarada*** *(supra)* and ***Tarulata Shyam*** *(supra)* it was the submission of the learned counsel for the assessee that the same were clearly distinguishable.

8. We have heard the learned counsel for the parties. A perusal of the order passed by the CIT(A) and impugned judgment of the Tribunal

clearly establishes that the money received by the assessee from CEI was in the nature of a trade advance. The learned counsel for the Revenue has not been able to demonstrate before us that concurrent findings of fact arrived at both by the CIT(A) and the Tribunal are in any manner perverse. Both the Tribunal and the CIT(A) after appreciating the evidence on record, the explanation of the assessee and the surrounding circumstances categorically rejected the conclusion reached by the Assessing Officer even with respect to the sum of Rs 8,35,000/- which the Assessing Officer had concluded was in the nature of a loan based on an erroneous communication which emanated from an accountant of CEI. These aspects have already been referred to in the earlier part of our judgment while recording the findings of the Tribunal and the CIT(A). We cannot in the present appeal re-appreciate the evidence or substitute our view with that of the CIT(A) or the Tribunal unless the same is demonstrably perverse.

8.1 This, however, leaves us with the submission of the Revenue that even a trade advance could fall within the ambit of Section 2(22)(e) of the Act. In order to deal with this submission it would be convenient to extract the relevant part of the provision of Section 2(22)(e) of the Act:-

> *"2. In this Act, unless the context otherwise requires,-*
>
> *xxxx*
>
> *xxxx*
>
> *(22) dividend includes:*
>
> *xxxx*

xxxx

(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 percent 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 (hereinafter 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."

9. A bare perusal of the aforementioned provision would show that a payment would acquire the attributes of a dividend within the meaning of the said provision if the following conditions are fulfilled:-

(i) The company making the payment is one in which public are not substantially interested.

(ii) Money should be paid by the company to a shareholder holding not less than ten percent (10%) of the voting power of the said company. It would make no difference if the payment was out of the assets of the company or otherwise.

(iii) The money should be paid either by way of an advance or loan or it may be "any payment" which the company may make on behalf of or for the individual benefit of any shareholder or also to any concern in which such shareholder is a member or a partner and in which he is substantially interested.

(iv) And lastly, the limiting factor being that these payments must be, to the extent of accumulated profits, possessed by such a company.

10. In the background of the facts obtaining in the present case, the submission of the Revenue is that, any sum paid whether forming part of assets of the company or otherwise by way of an advance to a shareholder holding more than 10% of the voting power in a closely held company would be deemed as dividend. In order to examine this submission we would have to examine the history and purpose with which the said provision was brought on to the statute book.

10.1 The immediate precursor to the said provision is found in Section 2(6A) of the Income Tax Act, 1922 (in short the '1922 Act'). With passing of the Amendment Act of 1939, Section 2(6A) (a) to (d) was inserted in the 1922 Act. It is common knowledge that there were several amendments brought about in the 1922 Act between 1946 and 1958. The attempt was to stem the tide of parallel economy which had fostered during the Second World War. One such attempt was made by setting up the Taxation Enquiry Commission (in short the 'Commission'). The Commission in its report of 1953-54 Volume II Chapter X, amongst others made the following suggestions with respect to the definition of the term 'dividend':

"36. The other suggestions received by us for the modification of the definition of the term 'dividend' may now be discussed.

We have already drawn attention to the suggestion that the following items should be included in the definition:-

(i) loans and advances to directors and shareholders of companies in which the public are not substantially interested; and
(ii) distributions in the form of deposit certificates or bearer certificates.

Both suggestions are intended to close loopholes for drawing upon retained profits of the company without attracting super-tax liability in the assessment of the shareholders.

37. The former is confined to companies in which the public are not substantially interested within the meaning of section 23A of the Income-Tax Act. ***The affairs of such companies are generally under the control of the principal shareholders who are in a position to utilize the funds of the company under the guise of loans without attracting super-tax liability.*** *The Australian and Canadian laws contain special provisions for the treatment of such loans as income of the shareholder in suitable cases. It is clear that the grant of such loans is capable of being used as a device to evade the objective of profit retention by the company.* ***We recommend, therefore, that the law should be amended so as to empower the income-tax authorities to treat loans and advances to directors and shareholders of such companies as dividends, where they are satisfied that they are made out of the accumulated profits of the company.*** *It will also be necessary to secure that, when such loans and advances are set off against dividends subsequently declared, they are not taxed as dividends a second time. We suggest that the law on the subject be modelled on the lines of a similar provision included in clause 2(c) (iii) of the Income-Tax (Amendment) Bill, 1951."*

(emphasis is ours)

10.2 The Finance Minister in his Budget Speech while introducing the Finance Bill acknowledged the fact that the insertion of clause (e) to

Section 2(6A) in the 1922 Act was being brought about based on the recommendations of the Commission. The relevant extract of the Speech reads as follows:-

> *"A number of other changes affecting the tax liability are being included in the amendments to the Income-tax Act embodied in the Finance Bill for the coming year in accordance with the recommendations of the Taxation Enquiry Commission. I do not propose to weary the House by explaining all of them in detail. Some of these involve bringing into the net certain incomes which were not being taxed."*

The Amended Section 2(6A)(e) read as follows:-

> ***"3. Amendment of Section 2, Act XI of 1922** – In Section 2 of the Income-tax Act,-*
>
> *xxxx*
>
> *xxxx*
>
> *(2) in clause (6A),-*
>
> *xxxx*
>
> *"(e) any payment by a company, not being a company in which the public are substantially interested within the meaning of section 23A, of any sum (whether as representing a part of the assets of the company or otherwise) by way of advance or loan to a shareholder or any payment by any such company on behalf or for the individual benefit of a shareholder, to the extent to which the company in either case possesses accumulated profits;"*

10.3 A bare reading of the recommendations of the Commission and the speech of the then Finance Minister would show that the purpose of insertion of Clause (e) to Section 2(6A) in the 1922 Act was to bring within the tax net monies paid by closely held companies to their

principal shareholders in the guise of loans and advances to avoid payment of tax.

10.4 Therefore, if the said background is kept in mind, it is clear that sub-clause (e) of Section 2(22) of the Act, which is pari-materia with clause (e) of Section 2(6A) of the 1922 Act, 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 these companies pay or distribute, what would legitimately be dividend in the hands of the shareholders, money in the form of an advance or loan.

10.5 If this purpose is kept in mind then, in our view, the word 'advance' has to be read in conjunction with the word 'loan'. Usually attributes of a loan are that it involves positive act of lending coupled with acceptance by the other side of the money as loan: it generally carries an interest and there is an obligation of re-payment. On the other hand, in its widest meaning the term 'advance' may or may not include lending. The word 'advance' if not found in the company of or in conjunction with a word 'loan' may or may not include the obligation of repayment. If it does then it would be a loan. Thus, arises the conundrum as to what meaning one would attribute to the term 'advance'. The rule of construction to our minds which answers

this conundrum is *noscitur a sociis*. The said rule has been explained both by the Privy Council in the case of ***Angus Robertson vs George Day: (1879) 5 AC 63*** by observing *"it is a legitimate rule of construction to construe words in an Act of Parliament with reference to words found in immediate connection with them"* and our Supreme Court in the case of ***Rohit Pulp & Paper Mills ltd vs Collector of Central Excise: AIR 1991 SC 754*** and ***State of Bombay vs Hospital Mazdoor Sabha AIR 1960 SC 610***.

10.6 It is important to note that ***Rohit Pulp*** *(supra)* was the case dealing with taxation. In brief in the said case the assessee was seeking to take benefit of an exemption notification. The Department denied the benefit of the 'notification' on the ground that the paper manufactured by the assessee was 'coated paper' to which as per the proviso to the said notification the concession was not available. The Supreme Court in coming to the conclusion that the assessee's case did not fall within the proviso and was thus entitled to the benefit of the notification applied the rule of construction of *noscitur a sociis.*

10.7 Importantly, the broad principles which emerge from the judgment of the Supreme Court with regard to the applicability of the said rule of construction are briefly as follows:-

(i) does the term in issue have more than one meaning attributed to it i.e., based on the setting or the context one could apply the narrower or wider meaning;

(ii) are words or terms used found in a group totally 'dissimilar' or is there a 'common thread' running through them;

(iii) the purpose behind insertion of the term.

10.8 Let's examine as to whether based on the aforesaid tests the said rule of construction '*noscitur a sociis'* ought to be applied in the instant case.

(i) the term 'advance' has undoubtedly more than one meaning depending on the context in which it is used;

(ii) both the terms, that is, advance or loan are related to the 'accumulated profits' of the company;

(iii) and last but not the least the purpose behind insertion of the term advance was to bring within the tax net payments made in guise of loan to shareholders by companies in which they have a substantial interest so as to avoid payment of tax by the shareholders;

10.9 Keeping the aforesaid rule in mind we are of the opinion that 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, in our view, fall within the ambit of the provisions of Section 2(22)(e) of the Act. This interpretation would alloy the rule of purposive construction with *noscitur a sociis,* as was done by the Supreme Court in the case of ***LIC of India vs Retd. LIC Officers Assn. (2008) 3 SCC 321***. The observation in para 24 of the report being apposite are extracted hereinbelow:-

> *"Each word employed in a statute must take colour from the purport and object for which it is used. The principle of purposive interpretation, therefore, should be taken recourse to"*.

11. A close examination of the judgment of the Bombay High Court in the case of ***Nagindas M. Kapadia*** *(supra)* would show that the Court excluded from the ambit of 'dividend', monies which the assessee had received towards purchases. In our view both the CIT(A) and the Tribunal have correctly appreciated this aspect of the matter in the said judgment of the Bombay High Court. The relevant portion of the judgment of the Bombay High Court which sets out this aspect of the matter is already extracted by us in the narrative give by us hereinabove. We are also in agreement with the view of the Tribunal that the judgment of the Supreme Court in the case of ***Ms. P. Sarada*** *(supra)* and ***Smt. Tarulata*** *(supra)* has no applicability to the present case. Both the judgments establish the principle that once the payment made to a shareholder is deemed as dividend then the mere fact that it

is repaid would not take it out of the ambit of the tax net. In the instant case, however, a discussion with respect to which has been made hereinabove, the issue is whether the payment received by the shareholder would at all fall within the four corners of provisions of Section 2(22)(e) of the Act. Having held otherwise, the said judgments of the Supreme Court, in our view, will have no applicability to the facts of the instant case.

12. In view of the above, the question of law as framed by us is answered in favour of the assessee and against the Revenue. We hold that trade advance does not fall within the ambit of the provisions of Section 2(22)(e) of the Act. Resultantly, the appeal is dismissed. There shall be, however, no order as to costs.

RAJIV SHAKDHER, J.

May 14, 2009 **VIKRAMAJIT SEN, J.**
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