

Various aspects of Taxability of

Deemed Dividend

covered u/s 2(22)(e) of Income Tax Act, 1961

By: CA Sanjay K. Agarwal

Dividend u/s 2(22)(e) is Taxable in the hands of.....

Shareholder

- ▶ Such dividends shall be taxable in the hands of the shareholder at normal tax rate u/s 56 of I.T. Act, 1961.

and

Company

- ▶ Shall not required to pay tax on such deemed dividend u/s 115 O of I.T. Act.

Note: Where as dividend u/s 2(22) (a), (b), (c), or (d) is exempt in the hands of shareholder u/s 10 (34) , the company shall pay CDT on it u/s 115 O of the I. T. Act.

Provisions of Deemed Dividend u/s Section 2(22)(e) of the Income Tax Act, 1961.....

Any payment by a company, not being a company in which the public are substantially interested, of any sum by way of advance or loan to.....

A
Shareholder

or

Any Concern

or

Any Person

▶ being the beneficial owner of shares holding not less than 10% of voting power

▶ in which such shareholder is a member or a partner and in which he has a substantial interest

▶ on behalf, or for the individual benefit of any such shareholder

to the extent to which the company possesses Accumulated profits.

“Substantial interest” in a concern - as per Explanation 3 of Sec. 2(22)(e).....

- 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 20% of the income of such concern.
- In the case of Company-a person should beneficially hold at least 20% Equity Share capital of the company.
 - To determining the Total no. of shares held in a company– shares held by a shareholder in his own name and held as guardian to be considered.

[Case law: CIT vs. Sokkalal (T.P.S.H) 236 ITR 981 (Mad.)(1999)]

Meaning of “Concern” - as per Explanation 3 of Sec. 2(22)(e).....

for this purpose “Concern” may be

- HUF
- Sole Proprietor
- Firm

- AOP
- BOI
- Company

- ▶ To determined the substantial interest of a person in a concern—*share held by him/her in two different capacities, e.g. as individual and as HUF cannot be clubbed.*

[Case law: CIT vs. Kunal Organics (P.O Ltd. 164 taxman 169 [2007] (Ahd.)]

Following conditions are required to be fulfilled for the applicability of Sec. 2(22)(e).....

- **Company**—should be one in which the public are not substantially interested i.e. should be a closely held company.
- **Person**—should be a shareholder having not less than 10% of voting power.
- **Payment**—should be by way of advance or loan.
and
made out of accumulated profits of the company.
- **In case loan or advance is to a concern**, shareholder should have a substantial interest in that concern at any time during the year.

Shareholder must be the beneficial holder of shares as well as a register holder of shares.....

- Where a loan is advanced to a shareholder, he/it **Must** be the registered as well as a beneficial owner of shares. However, where the shareholder is a beneficial holder but not the registered holder of shares, even then section 2(22) (e) would not attract to him.

*[Case law: Rameshwarlal Sanwarmal vs. CIT
122 ITR 1 [1980] (SC)]*

Meaning of Loan & advances.....

According the 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.
- **Advances** means something which is due to a person but which is paid to him ahead of time when it is due to be paid.

Factors to be considered w.r.t. Loan or Advance.....

- A loan of money results in a debt but every debt does not involve a loan.

[Case law: **Bombay Steam Navigation Co. (P) Ltd. V. CIT 56 ITR 52 (1953) (SC)**]

- A loan for few days would be within its ambit. Thus duration of loan is not material.

[Case law: **Walchand & Co. Ltd. vs. CIT (1975) 100 ITR 598 (Bom)**]

- An overdraft taken by shareholder from the company is treated as loan and taxable as deemed dividend.

[Case law: **CIT vs. K. Srinivasan 50 ITR 788 (1963) (Mad.)**]

Contd.....

- Payment by the company towards the personal expenses of the shareholder would be treated as deemed dividend.

[Case law: CIT V. K. Srinivasan 50 ITR 788 (1963) (Mad)]

- Loan obtained by the shareholder through proprietary concern would be treated as deemed dividend u/s 2(22)(e).

[Case law: CIT V. K. Srinivasan 50 ITR 788 (1963) (Mad)]

- Withdrawal over and above of credit balance is to be treated as deemed dividend.

[Case law: CIT V. P. Sarada 154 ITR 387 (1985) (Mad)]

Contd.....

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

[Case law: CIT V. L. Alagusundaram Chettiar 109 ITR 508 (1977)(Mad.)]

- A loan in kind attract the provisions of deemed dividend.
 - Any payment by a company of any sum representing a part of the assets by way of advance made by the company to the shareholder by the transfer of goods would come in to the provisions of sec. 2(22)(e)

[Case law: M.D. Jindal vs. CIT 164 ITR 028 (Cal.)(1987)]

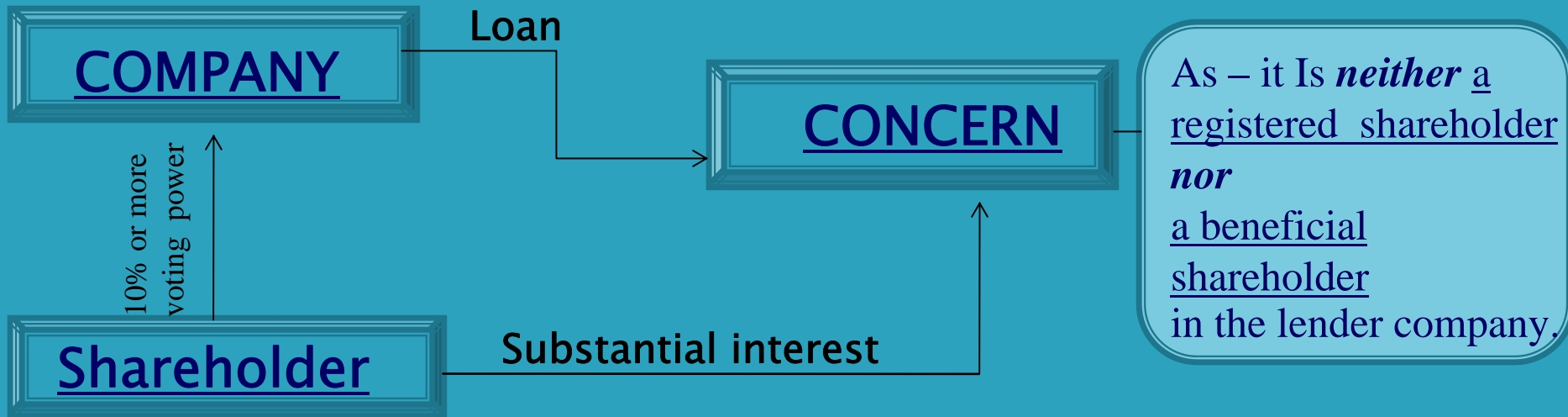
Deemed dividend u/s 2(22)(e) is taxable in hands of the **Ultimate Recipient** of the loan amount....

- ▶ 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.

Where a loan or advance is made to a concern in which shareholder as referred in the section is substantially interested, taxability should not arise in the hands of that concern but in the hands of the shareholder having beneficial interest in the concern and that too when the money is finally received by that shareholder.

[Case law: ACIT vs. Bhaumik Colours (P.) Ltd [2009] 118 ITD 1(Mum.) (SB)]

A loan/advance made by a company to a concern in which its shareholder has a substantial interest.....



Is Not taxable in the hands of Concern as deemed dividend u/s 2(22)(e).

[Case law: CIT v. Hotel Hilltop 313 ITR 116 (Raj.) (2009)]

[Asst. CIT v. Bhaumik Colour P. Ltd. 313 ITR 146 (ITAT-Mum.)(S)(2009)]

[Shruti Properties P. Ltd. V. ITO 004 ITR 186 (ITAT-Mum.)(2010)]

Contd.....

- A firm was working as sub-contractor with a company and had received interest-free advances from said company.
 - Since the firm was not a shareholder of the company and only partners of firm were shareholders of the company, therefore the loan advanced by company to firm could not be deemed to be dividend in the hands of the firm.

[Case law: CIT vs. Raj Kumar Singh & Co. 149 TAXMAN 254 [2005] (All.)]

- An advance is made by a closely held Indian company to a foreign subsidiary (which did not itself hold any shares in it but its foreign holding company with other subsidiaries has substantial interest in the Indian company), would not come in to the view of sec. 2(22)(e).

[Case law: Madura Coats P. Ltd. 274 ITR 609 AAR (2005)]

- A company has made a loan to its shareholders who are the partners of a firm. The shares held by them are shown as stock in trade of the firm and the amount received by the partners are shown as deposit made by the company in the books of the firm. Then the loan could not be deemed dividend in the hands of the firm u/s 2(22)(e).

[Case law: ITO vs. Chandmull Batia 115 ITR 388 (1978)]

- A company made a loan to the HUF and a member of HUF purchased shares of the company with the funds of family. The said amount could not be considered as deemed dividend in the hands of the firm.

[Case law: CIT vs. Sarathy Mudaliar (C.P) 83 ITR 170 (1972)]

- Any money transferred to any concern in which the shareholder had a substantial interest, from the funds defalcated by the said shareholder and allowed as business loss to the company.
 - The said amount is not a deemed dividend in the hands the concern.

[Case law: CIT V. Universal Medicare Pvt. Ltd. 324 ITR 263 (2010)(Bom.)]

- A loan by the company to the firm in which its shareholder has substantial interest and from firm to the shareholder, then the burden on revenue to prove that transactions are inter-related.
 - If there is no nexus between the funds of company with firm and loan to him- the loan cannot be treated as deemed dividend.

[Case law: Subrata Roy Sahara vs. Asst. CIT 294 ITR 235 (ITAT-Luck.)]

Crux.....

- ❑ Where a loan or advance is made by a company to a concern in which the shareholder has a substantial interest, then the such money is not taxable in the hands of a concern.
- ❑ But in the hands of the shareholder subject to the condition that the money must be finally received to him.

Sec. 2(22)(e) gets attracted even if...

- ▶ Company charges interest equal to the market rate of interest from its shareholder on loans or advances given to him.
- ▶ Advance is given for expense & advance is adjusted against expense.
- Loan is repaid before the end of the previous year .i.e. liability is attracted at the movement the loan is given. [Case law: Tarulata Shyam vs. Cit 108 ITR 345 (1977) (SC)]

Note: TDS shall be deducted by the company on such payment.

Contd.....

- A closely held company paid a sum to a firm in which its major shareholder is a partner and he withdraw a sum from his capital account and make investment. Then said sum is assessed as deemed dividend in the hands of the shareholder.

[Case law: CIT vs. Mukundray K. Shah 290 ITR 433 (2007) (SC)]

- company paid any amount to a shareholder and the same is disclosed by the shareholder as loan in his balance-sheet, subject to fulfillment of the conditions of Sec. 2(22)(e) is deemed dividend.

[Case law: Asst. CIT V. Ajay Jadeja 005 ITR 233 (2010) (ITAT-Del.)]

But Sec. 2(22)(e) - not attracted.....

- If an amount is given to a Shareholder for the purposes of making an advance in respect of certain land dealings which were proposed to be entered into by the company through him.
 - Since the amount was given to the shareholder was in the nature of imprest payment, the same could not be treated as deemed dividend under Section 2(22)(e) of the said Act.

[Case law: CIT V. Sunil Sethi 26 SOT 95 (ITAT-Del.) (2010)]

Contd.....

- Amounts advanced by a company to its director under a Board resolution, for specific purpose, would not fall under mischief of section 2(22)(e).

[Case law: ACIT vs. Harshad V. Doshi 9 Taxmann.com 48 (Chennai - ITAT) (Bench-'D') (2011)]

Some Important point to be considered.....

- ▶ If loan amount $<$ Accumulated profits then entire amount of loan is considered as deemed dividend.
- If a loan is given by a company to a shareholder, the amount of loan to the extent of entire Accumulated profits (and not to the extent of his share in Accumulated profits) will be treated as dividend.

[Case law: CIT v. Arati Debi [1978] 111 ITR 277 (Cal.)]

[CIT v. Mayur Madhukant Mehta [1972] 85 ITR 230 (Guj.)]

Note: Deemed dividend is taxable on Accrual basis i.e. in the “previous year” in which the payment was made (Sec. 8(a)).

Contd.....

- ▶ Repayment of loan or advance during the year will not affect the applicability of sec. 2(22)(e).
- Repayment of loan can't be reduced from deemed dividend. **[Case law: Rajesh P. Ved v. Asst. CIT 001 ITR 275 (ITAT-Mum.)(2010)]**
- Repayment of a deposit made by a shareholder with the company does not attract the provisions of Sec. 2(22)(e).
[Case law: Mohan Anand vs. CIT 82 ITD 708 (Del.)(2002)]

- ▶ Recipient should be a Shareholder on the date the loan was advanced.[Case law: CIT vs. Mittal (H.K.) 219 ITR 420 (All.)(1996)]
- Subsequent adjustments in the shareholder's account on the last day of accounting year would not alter the position that the shareholder had received notional dividends during the relevant period.[Case law: Sarada (P.) (Miss.) vs. CIT 229 ITR 444 (SC)(1998)]
- Deemed dividend assessed, if any in the hands of the shareholders in the past assessment years should be deducted from the surplus while determining the accumulated profits in the hands of the company.
[Case law: CIT V. G. Narasimhan 102 Taxman 66/236 ITR 327 (1999) (SC)]

Contd.....

- *There must be an actual flow of cash from the company to the shareholder.*
 - Only a transfer of money from the account of one shareholder (husband) to an other shareholder's account (wife) in the books of company, would not amount to payment as envisaged u/s 2(22)(e).

[Case law: CIT vs. Smt. Savithiri Sam 236 ITR 1003 (Mad.)(1999)]

Note: If there are no accumulated profits, there would not be any question of loan being treated as deemed profits

Contd.....

- When a Shareholder doing business with company & always having debit balance, the amount would be regarded as loan by the company and to the extent of Accumulated profits to cover the debit balance, would be regarded as deemed dividend u/s 2(22)(e).

[Case law: CIT vs. Jamnadas Khimji Kothari 92 ITR 105 (1973) (Bom)]

- If there is no transaction between shareholder and company during the relevant accounting period. The debit balance of shareholder's account in the books of a company is not assessed as deemed dividend u/s 2(22)(e).

[Case law: Asst. CIT vs. Smt. Lakshmikutty Narayanan 303 ITR 212 (ITAT- Coc.)]

- Share forfeiture receipts – are not accumulated profits.

[Case law: Jai Kishan Dadlam (2005) 4 SOT 138 (Mum)]

- While calculating Accumulated profits an allowance for Depreciation and additional depreciation at the rates provided by the I.T. Act itself has to be made by way of deduction.

[Case law: Navnital C. Jhaveri V. CIT 80 ITR 582 (1971) (Bom)]

Contd.....

Accumulated profits includes.....

- General Reserve [Case law: CIT vs. K. Srinivasan 50 ITR 788 (Mad.)(1963)]
- Development Rebate reserve, Development Allowance Reserve and Investment Allowance Reserve, as these reserves are in the nature of any expenditure or outgoing. [Case law: P.K. Badiani vs. CIT 105 ITR 642 (1976)(SC)]
- Building Reserve Fund [Case law: CIT vs. Jaldu Rama Rao 11 Taxman 203 (1982)(AP)]

Contd.....

Subsequently declared dividend set off against previously granted loan:-

- ▶ Where a loan granted by the company is treated as dividend under section 2(22)(e) and the company subsequently declares regular dividends and sets it off against the said loan, the dividends so set off would not be treated as dividend in the hands of the shareholder.

Contd.....

- Sec. 2(22)(e) covers only the amount received during the P.Y. by way of loans/advances and not amounts received in an earlier year.
 - Further, increase in the outstanding on account of provision for interest is not covered

[Case law: CIT V. Parle Plastics Ltd (ITA No. 37 of 2002) (Bom.)]

- Amount credited in the loan account by way of remuneration to the a shareholder cannot be set off against loan.

[Case law: Rajesh P. Ved vs. Asst. CIT 001 ITR 275 (2010) (ITAT-Mum.)]

Contd.....

- In the case where there was no finding that payment is made out of Accumulated profits or the company possessed accumulated profits, then the loan to the shareholder is not assessable as deemed dividend.

[Case law: CIT vs. Nitin Shantilal Parikh 319 ITR 437 (2009) (Guj.)]

❖ Exceptions
to Section 2(22)(e)
of Income Tax Act, 1961

1. *Business Transactions are out of the preview of provisions of Sec. 2(22)(e)....*

As per the exceptions to clause (e) to section 2(22) provides 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.

What constitutes "Substantial part of the company's business"?.....

“Substantial part of the company's business” has not been defined under the I.T. Act.

- Ratio of money lending business should be 20% or more to be considered "substantial part of the company's business."

[Case law: Mrs. Rekha Modi v. ITO 13 SOT 512 (2007)(ITAT-Delhi)]

Note: Factual position of the company for the relevant 'previous year' i.e., the year in which the loan or advance was made, should be considered.

- “substantial part” does not connote an idea of being the “major part” or the part that constitutes majority of the whole. Any business which the company does not regard as small, trivial, or inconsequential as compared to the whole of the business is substantial business.
 - Various factors and circumstances such as turnover, profit, employees, capital employed etc are required to be looked into while considering whether a part of the business of a company is a “substantial part of its business”

[Case law: CIT V. Parle Plastics Ltd (ITA No. 37 of 2002)
(Bom.)]

Business transaction.....

- Therefore, the provisions of sec2(22)(e) shall not apply if....
 1. payment is in the nature of an **advance or loan** and
 2. loan is in the **ordinary course of business** of money lending.

[Case law: ITO vs. Krishnonics Ltd 308 ITR 008 (ITAT-Ahm.) (2009)]

- In the case of CIT vs. Badiani (P.K.) 76 ITR 369 (1970) (Bom.), it is held that.....

“What has to be considered is not the balance in account but the position of every payment, and , therefore, the debit balance of the shareholder with the company at any point of time could not be taken to represent an advance or loan by the company to the shareholder; nor could the amount outstanding at the end of the accounting year alone be taken as loan within the meaning of section 2(22)(e).”

Contd.....

- Onus is on the Assessee to prove the fact that the loan or advance is in the "Ordinary Course of Business" and Lending of money constitutes substantial part of the company's business.

[Case law: Walchand & Co. Ltd. V. CIT 100 ITR 598 (1975) (Bom.)]

- No interest is charged by a company on loan/advance made by it in the "Ordinary Course of Business" and Lending of money is the sole business activity but charged commission, etc even then it is not covered under deemed dividend.

[Case law: Jhamu U. Sughand vs. Dy. CIT 284 ITR 082 (ITAT-Mum.) (2006)]

2. Trade advances given by the company...

- The advances which are in the nature of trade advances are outside the ambit of provisions of Sec. 2(22)(e) of the I.T. Act, 1961.

[Case law: CIT vs. Rajkumar 318 ITR 462 (Del) (2009)].

- Any advance paid by a company to its sister concern holding 50% of shareholding in the company and latter adjust the advance against dues for job work to be done by the company , is a business transaction.

[Case law: CIT vs. Creative Dyeing and printing Pvt. Ltd. 318 ITR 476 (Del) (2009)]

- However, where company has made advances to the concern of the shareholder towards purchases to be made by the company from the said concern, such advances would not be deemed dividend u/s 2(22)(e).

[Case law: CIT vs. Nagindas M. Kapadia 177 ITR 393 (1989) (Bom)]

3. Inter-Corporate Deposits (ICDs).....

- ICDs are different from loans or advances & would not come within preview of deemed dividend u/s 2(22).

[Case law: Bombay Oil Industries Ltd. V. Dy. CIT 28 SOT 383 (Mum) (2009)]

4. Financial transaction.....

- Financial transactions in any circumstances could not be treated as loans or advances and therefore not come into the provisions of deemed dividend.

**[Case law: CIT vs. Ambassador Travels P. Ltd. 318
ITR 376 (Del) (2009)]**

Income shall be excluded from
Accumulated profits.....

Accumulated Profits

- *“Accumulated profits within the meaning of clause (e) will necessarily be comprised of the amount available for being distributed as profits. The word 'accumulated' means the profit earned bit by bit and accumulated. It does not mean that it should be carried forward from year to year. Profits can accumulate even within a single year. The entire amount which is available for distribution as profits on a particular date would be the accumulated profit and any amount paid as advance or loan to the shareholder to the extent of this amount of accumulated profits will be dividend within the meaning of section 2(6A)(e).”*

[Case law: CIT v. Roshan Lal 98 ITR 349 (1975) (ALL.)]

1. *Non-taxable Accumulated Capital Gains.....*

- Accumulated profits would not include capital gains which are not chargeable to tax even during the period the capital gains tax is in force. Distribution made to the shareholder of a company out of non-taxable accumulated capital gains of a company would not be dividend.”

[Case law: Tea Estate India P. Ltd. vs. CIT 103 ITR 0785 (1976) (SC)]

2. Tax Free Income.....

- The basic intention behind the section is to tax that part of parts which could otherwise be distributed as dividend reach in the hands of shareholders in the form of loan or advances.

Thus, it was to tax that income which could be taxed. In view of this, where a part of that profits comprises of the income which is not chargeable to tax or which is tax free, same should be excluded while applying the provisions of section 2(22)(e).

[Case law: CIT vs. Mangesh J. Sanzgiri 119 ITR 0962 (1979)(Bom.)]

3. Share Premium Account.....

The Income Tax Act, 1961 does not specifically define accumulated profits.....

But Explanation 2 to section 2(22) of the Act, provides to include in the accumulated profits, all the profits up to the date of distribution.

As per Schedule VI of the Companies Act, 1956, Accumulated profits is not defined but it considers Reserves and Surplus comprising of the following:

- (1) Capital Reserves
- (2) Capital Redemption Reserve
- (3) **Share Premium Account**
- (4) Other reserves specifying the nature of each reserve and the amount in respect thereof.
 - Less: Debit balance in profit and loss account (if any).
- (5) Surplus, i.e., balance in profit and loss account after providing for proposed allocations, namely :–
 - Dividend, bonus or reserves
- (6) Proposed additions to reserves

- Thus, reserves in (1) to (3) are specifically assigned a purpose.
- However, reserves from (4) to (6) are the reserves which can be used for distribution of dividend i.e. these are distributable profits of the company.

- ▶ Therefore..... Dividend can be declared by the company only out of revenue reserves and not from the capital reserves.
- ▶ Notification [GSR No. 427(E), dated July 24, 1975] of Companies (Declaration of Dividend out of Reserves) Rules, 1975
Puts a restriction on the utilization of capital reserves for the purpose of dividend declaration.

Provisions of Sub Sec. (2) of Sec. 78 of the Companies Act, 1956.....

Specifically imposes a restriction on the utilization of Securities Premium Account providing as under:

The “Securities Premium Account” may, notwithstanding anything contained in sub-section (1), be applied by the company-

- In paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares;
- In writing off the preliminary expenses of the company;
- In writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company; or
- In providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Contd.....

- *“since section 78 of Companies Act, 1956 puts a statutory bar on share premium account being used for distribution of dividend, deeming provisions of section 2(22)(e) cannot apply and, hence, payment made by a company out of its share premium account could not be brought to tax in hands of receiver as deemed dividend under section 2(22).”*

[Case law: DCIT vs. MAIPO India Ltd., 116 TTJ 791(Del-ITAT)]

[Case law : CIT vs. Urmila Ramesh (1998) 230 ITR 422 (SC)]

also not includes

- Provisions for Taxation & Dividend.

[Case law: CIT vs. Damodaran 85 ITR 590 (1972)(Ker.)]

- Balancing charge u/s 41(2) is not part of accumulated profits.

[Case law: CIT vs. Urmila Ramesh 96 Taxman 533 (1998)(SC)]

- Subsidy on capital account.

[Case law: CIT vs. Rajasthan Wires (P.) Ltd 130 Taxman 93 (2003) (Jp.) (Mag.)]

Deemed Dividend in the hands of a Non-Resident Shareholder.....

- ▶ Sec. 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-sec. (1) of sec. 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 NR Shareholder subject to DTAA relief.

Reporting of Deemed Dividend by the Auditor – in case of Audit u/s 44AB of the Income Tax Act....

- ▶ There is no specific provision in the Audit Report Form No. 3CD prescribed by the I.T. Rules, 1962 for reporting of 'Deemed Dividend' paid by a Company.

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, 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.

Thank You

**By: CA Sanjay K. Agarwal
agarwal.s.ca@gmail.com
Mob: 9811080342**