DEEMED DIVIDEND

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The concept of Deemed Dividend under the Income-tax Act, 1961(the Act) is not new. However, time and again many closely held company assessees and their controlling shareholders, to their surprise and dismay, realise very late the importance of this powerful taxing tool in the hands of the Assessing Officer.

The concept of Deemed Dividend is embedded in Section 2(22)(e) of the Income-tax Act, 1961 and was also embedded in section 2(6A)(e) of the Indian Income-tax Act, 1922. In nutshell, the concept envisages taxing certain payments made by closely held companies by way of loans or advances to certain shareholders of the company or to the concerns/companies in which they have substantial interest. Whenever any payment is made by way of loan or advance, the recipient of the loan or advance will be liable to be taxed on this amount as a dividend, to the extent to which the company has accumulated profits, under the deeming provisions of section 2(22) (e) although such loan or advance may have been given for genuine business purposes and even if the paying company may have received back the loan amount. Thus the section deems certain payments as dividend income which is not income under ordinary commercial parlance. Therefore, the name Deemed dividend.

The concept of deeming certain payments or loans or advances to substantial shareholders as income was introduced with the object of curbing tax evasion. Upto 31-5-1997 dividend was taxed in the hands of the recipient of the dividend. However many closely held companies never declared any dividend and accumulated profits in the company itself. Since no dividend was declared the same could not be taxed. However the companies did give loans or advances to substantial shareholders or to their concerns/companies who presumably enjoyed these funds but were not liable to pay any tax on the same as the amounts were loans or advances liable to be returned. These amounts of loans or advances are sought to be taxed as dividend by section 2(22)(e) of the Act by way of a deeming fiction.

Taxation of dividend under Income-tax Act, 1961 has undergone substantial changes in recent times. Effective from 1-6-1997 the scheme of taxation of dividend has been modified and is different from the old scheme. The essence of the old scheme was that the recipient of the dividend income was liable to pay the income-tax on the same, subject to certain exemptions. The new scheme essentially makes the dividend tax-free (section 10(33) of the Act) in the hands of the recipient (except cases covered under section 2(22(e)of the Act) and the dividend paying company has been made liable to pay tax on the amount of dividend declared , distributed or paid by it (Section 115-O of the Act). This tax is over and above the corporate income-tax which a company would normally pay. However there is no change in the scheme of taxation of Deemed Dividend contained in the section 2(22) (e) of the Act and such dividends are governed by the old scheme of taxation of dividend i.e. tax on deemed dividend is paid by the recipient and the paying company does not have to pay dividend tax but will be liable to deduct tax at source from such loans or advances/deemed dividend and pay the same to the Government.

Section 2 (22)

Section 2(22) has 5 clauses (a), (b), (c), (d) and (e) which specify various types of distributions and payments as dividend. Clauses (a), (b), (c) and (d) mainly cover cases of distributions which entail release of assets or create liabilities. While clause (e) covers cases of payments by way of loans or advances and which is the clause mainly dealing with deemed dividend as it is commonly understood and has been dealt with in this article.

In Kantilal Manilal v.CIT [1961] 41 ITR 275(SC) the Supreme court held that Section 2(22) deals with various types of cases and creates a fiction by which certain receipts or parts thereof are treated as dividend for the purpose of levy of Income-tax .

In CIT v. Martin Burn Ltd.,(1982)136 ITR 805(cal) the Calcutta High court held that Under section 2(22) certain amounts which are actually not distributed are also brought within the net of dividends. Therefore, that section must receive a strict interpretation.

Section 2(22)(e) has been held to be constitutionally valid in Navnitlal C. Javeri v. K.K.Sen, AAC [1965]56 ITR 198 (SC).

Section 2(22) starts with the words " Dividend includes ……..."Thus the definition of dividend is inclusive and not exhaustive.

Section 2(22)(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 (hereafter in this clause referred to as 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;"

Let us now analyse the clause in detail.

Section 2(22) of Income-tax Act, 1961 defines "dividend" and is the main section for taxation of Dividend. Unless a payment or distribution is covered by this definition, it can not be taxed as "dividend". Once an amount is covered as dividend it will be also considered as income as Section 2(24) (ii) of the Act includes 'dividend' within the definition of 'Income'.

Companies in which Public are not substantially interested

As it is clear, clause (e) applies only to companies in which public are not substantially interested i.e. to companies which are commonly known as closely held companies. Section 2(18) of the Act defines a "Company in which public are substantially interested". Section 2(22)(e) does not apply to listed companies, government companies, section 25 companies, companies having no share capital and declared by Board, mutual benefit finance companies declared by Central Government to be a Nidhi or Mutual Benefit society, companies in which one or more co-operative societies hold at least 50% voting shares throughout the year, etc.

Payment of any Sum

Clauses (a),(b),(c) and (d) of section 2(22) use the word "distribution" while clause (e) uses the word "payment" which means amount may have been disbursed to one or two or more shareholders and not necessarily be distributed to all the shareholders.

Does it mean only payment by cash/cheque or will it cover loan in kind also? Whether a goods loan will be covered? In M.D. Jindal v. CIT [1986] 28 Taxman 509 (Cal.) it was held that Section 2(22)(e) is applicable even if a loan is given in kind. Thus a loan of goods or other assets will also be covered by the clause and it is not necessary that the loan or advance must be given in cash only.

Shareholder

The shareholder may be even a corporate entity. Loan given by a subsidiary company to a holding company will be covered by clause (e).

Loan or advance

Section 269SS of IT Act specifies that ' for the purpose of this section," loan or deposit" means 'loan or deposit of money'. A loan creates a relationship of a lender and a borrower.

Can a bonafide loan given to a major shareholder for a short duration be covered by this section? In CIT v. Bhagwat Tewari [1979] 105 ITR 62 (Cal) it was held that a bonafide loan for a short duration is treated as dividend if all the conditions of section 2(22) (e) are satisfied.

What is the position when a shareholder has a current account with the company? When a current account shows a debit balance of the shareholder in company's books, it will take character of a loan. Therefore, position after every entry will have to be ascertained.

In order to attract the provisions of section 2(22)(e), the important consideration is that there should be loan/advance by a company to its shareholder. Every payment by a company to its shareholder may not be loan/advance. To be treated as loan every amount paid must make the company a creditor of the shareholder for that amount. If, however, at the time when payment is made, the company is already the debtor of the shareholder, the payment would be merely a repayment by the company towards its already existing debt. It would be a loan by the company only if the payment exceeds the amount of its already existing debt and that too only to the extent of the excess. If the shareholder has a current account with the company, the position as regards each debit will have to be considered individually, as it may or may not be a loan. In such case the debit balance of the shareholder with the company at any point of time cannot be taken to represent an advance/loan by the company; nor can the amount at the end of the previous year be alone taken as loan.CIT v. P.K. Badiani[1970] 76 ITR 369 (Bom.).

Whether an overdraft taken by a major shareholder from the company will be covered as deemed dividend? An overdraft taken by a shareholder from the company is treated as loan and taxable as dividend if conditions of section 2(22)(e) are satisfied—CIT v. K..Srinivasan [1963] 50 ITR 788 (Mad.).

What will be the position when a major shareholder misappropriated some amount from the company? Amount misappropriated by the director cannot be treated as deemed dividend in his hands since in such a case there is no lending or advancing by the company. It cannot be said that in such a case the company has paid anything and unless there is an actual payment by the company as a loan or advance to the assessee, it cannot be treated as dividend under section 2(22)(e). CIT v. G. Venkataraman [1975] 101 ITR 673 (Mad.)

If a loan is repaid before the end of the previous year, the section will be attracted? Yes, even if a loan is repaid before the end of the previous year the section will be attracted. In Tarulata Shyam v. CIT [1977] 108 ITR 345 (SC) the Supreme court held that under section 2(22) the liability to tax attaches to any amount taken as loan by the shareholder from a controlled company to the extent it possesses accumulated profits at the moment the loan is borrowed and it is immaterial whether the loan is repaid before the end of the accounting year.

Whether Book debts will be covered by "loans and advances"? Where the assessee-shareholder, having business of his own, was transacting business with the company and the account of the assessee in the company always showed a debit balance, it was held that the said debit balance would amount to a loan from the company to the assessee. CIT v. Jamnadas Khimji Kothari [1973] ITR 105 (Bom.)

Every sale of goods on credit does not amount to a transaction of loan. A loan contracted no doubt creates a debt but there may be a debt without contracting a loan. Bombay Steam Navigation Company P. Ltd. v. CIT(1965) 56 ITR 52(SC).

Whether Security deposit to a major shareholder for use of premises will be covered under clause (e)? Genuine security deposit without any element of loan may not be considered as a loan.
Whether loans or advance to relatives of a major shareholder will be covered? Loans to relatives of substantial shareholders are not covered as loans or advances to the shareholder. However such loans or advances may be covered as" payment on behalf of or for the individual benefit" of the shareholder.

Clause (ii) to section 2(22) provides that "dividend" does not include any advance or loan made to a shareholder [or the said concern] by a company in the ordinary course of business, where the lending of money is a substantial part of the business of the company;

If a majority of a company's assets and income are from money-lending business, it will be proper to assume that lending of money is a substantial part of the company's business.

In Walchand & co. Ltd. V. CIT,(1975)100 ITR 598(Bom) it was held that the onus to prove these facts lies on the assessee.

Clause (iii) to section 2(22) provides that "dividend" does not include any dividend paid by a company which is set off by the company against the whole or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (e),to the extent to which it is set off.

This clause gives some relief to the assessee by way of avoiding double taxation as well as brings in some scope for Scope for tax-planning. Thus, if a loan is already treated as a dividend it may make sense to declare dividend and adjust the outstanding loan amount against the dividend declared. No tax will be payable by shareholder on such dividend declared.
However, if the loan has been repaid by the shareholder and nothing is due by the shareholder against the loan referred in section 2(22)(e), then no set-off would be possible. Also if the sum due by the assessee is on account of some other payments not covered by section 2(22)(e), then set-off will not be possible.

It appears that liability to pay tax on distributed profits u/s 115-O can not arise in a case where a dividend paid by a company is set-off by the company as mentioned above, since the amount itself is not to be treated as a dividend. Explanation to section115Q may be referred to for this purpose.

Payment on behalf of or for the individual benefit of a person
A benefit means some advantage to a person or something for the good of a person.

A managing director of a company, whenever he needed money used to ask an employee to take a loan from the company and pass it on to him even without executing any pronote. Can he be said to have received any benefit? It was held that the loans made by the company to the employee fell in the category of "benefit" to the assessee managing director and were, therefore, assessable as deemed dividends in his hands—CIT v. L.Alagusundaram Chettiar [1977] 109 ITR 508 (Mad.).

In one case, the assessee, having substantial interest in a company X, obtained from company Y two loans of Rs. 75,000 and Rs.2,00,000 on July 30, 1968 and September2, 1968, respectively. The question for consideration was whether these amounts could be treated as deemed dividend in the hands of the assessee under section 2(22)(e) on the ground that Y had made these loans to the assessee out of loans received by Y from X on the same dates. The Court held (in Nandlal Kanoria v. CIT [1980] 122 ITR 405 (Cal.)), that there was no loan given by X to the assessee. However, as the loan of Rs. 75,000 was given by Y to the assessee out of an equal amount received as loan from X on the same date, this amount was a payment by X for the benefit of the assessee and fell within the mischief of section 2(22)(e). The same could not be said of the loan of Rs. 2,00,000, as on the date of making that loan, Y had received loans not only from X but from another source also and the loan was made out of blended amount.

Of accumulated Profits
In P. K. Badiani v CIT(1976)105 ITR 642(SC) the Supreme court held that Accumulated profits mean commercial profits and not assessed income. It does not mean the aggregate of the assessed income arrived at after disallowing disbursements and expenditure in fact incurred.

In Navnitlal C. Jhaveri v. CIT [1971]80 ITR 582(Bom) a question arose that while calculating accumulated profits depreciation as per books should be considered or as per IT Act? The Bombay High court held that while calculating accumulated profits an allowance for depreciation at the rates provided by the Income-tax Act itself has to be made by way of deduction.

This is an important saving grace and assessees can claim substantial deduction for Income-tax depreciation out of accumulated profits. This will also call for separate calculation for accumulated profits as per income-tax Act and the same may be different from the accumulated profits as per books of accounts.

As the Accumulated profits have to be commercial profits, additions made by the ITO due to concealed income can be included in accumulated profits. However, by the same logic, additions made by the Income-tax officer on account of inadmissible expenses or disallowances can not be included in accumulated profits.

Even loan obtained by the assessee-shareholder from a company from out of its Accumulated profits, which are exempt in the hands of the company as agricultural income, is to be treated as deemed dividend in the hands of the assessee. S. Kumaraswami v.ITO [1961] 43 ITR 423 (Mad.)

In determining the Accumulated profits available for the purpose of section 2(22)(e), the amount treated as deemed dividend under section 2(22)(e) in past have to be excluded. CIT v. G. Narasimhan [1979] 118 ITR 60 (Mad).

Thus it will be imperative for the company to calculate its profits and losses up to the date of payment of loan or advance and then calculate Accumulated profits (or losses).This date may be a date in between the two accounting years. In fact for every loan to such shareholder/concern the company may have to prepare profit and loss account up to that date.

Whether capitalised or not

These words which are found in clauses (a) to (d) are not found in clause (e) of section 2(22) and, therefore, that provides some relief from the mischief of the section as well as provides some scope for planning .Thus it must be interpreted that to the extent of capitalisation of profits, accumulated profits would reduce for the purpose of this clause but not for other four clauses of section 2(22). What is capitalisation? It will ordinarily mean conversion of profits or reserves or income into capital as per Company's Articles of Association.

In P.K.Badiani v. CIT (1976)105 ITR 642 (SC) the Supreme court held that mere transferring of an amount from Profit & Loss account to the Development Reserve account or any other Reserve does not amount to capitalisation of profits.
Similarly a transfer to General Reserve will not amount to capitalisation.

The reason for allowing reduction of the accumulated profits to the extent of capitalisation of profits seems to be that to the extent of capitalisation, divisible profits i.e. profits available for distribution of dividend will reduce. A company can not distribute dividends out of capitalised profits i.e. capital. Thus if a closely held company wants to give loan or advance to a shareholder or his concern/company which are covered by this clause, it may first issue bonus shares (and thus capitalise the accumulated profits) and then grant such loan or advance. This is one sure way of escaping from the clutches of section 2(22)(e). However, it may involve expenses of filing fees and stamp-duty on increase of authorised share capital. Also a company may not want to increase its capital due to various other reasons.

Quantum of dividend

A question that arises is whether the quantum of deemed Dividend assessable in the hands of the assessee will be restricted to his share in the accumulated profits?

In CIT v. Mayur Madhukant Mehta [1972] 85 ITR 230 (Guj.) it was held that there is nothing in sub-clause (e) of section 2(22) to restrict the deemed dividend to that portion of Accumulated profits which corresponds to the assessee's shareholding in the capital of the company.

If a loan is given by a company to a shareholder who owns 25 percent of share capital, the amount of loan to the extent of entire Accumulated profits (and not to the extent of 25 percent of Accumulated profits) will be treated as dividend. CIT v. Arati Debi [1978] 111 ITR 277 (Cal.).

When a loan is treated as a deemed dividend and is repaid by the shareholder will it be added in the "accumulated profits"? Section 2(22)(e) must be so interpreted that once an amount goes out of "accumulated profits" as a loan and the loan is to be deemed as dividend the same amount when repaid cannot again be capable of attracting fiction and be deemed as dividend.. To avoid the happening of any such eventuality, the "accumulated profits" must be notionally reduced by the amount of all loans which are to be treated as dividends under section 2(22)(e) .CIT v. P.K. Badiani. [1970] 76 ITR 369 (Bom.).

Benficial owner of not less than 10% of the voting power

It is not the registered shareholder but the beneficial owner of the shares who is covered by the section 2(22)(e). Also the shareholding as on the date of the loan has to be considered. If preference shareholders are entitled to vote due to default in payment of dividend or in redemption, their holding will also have to be counted.

Concern in which Substantial interest

Section 2(32) of the Act states that a "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."

As per Explanation 3(b) to Section 2(22) a person shall be deemed to have a substantial interest in a concern, other than a company, if he is, at any time during the previous year, beneficially entitled to not less than twenty percent of the income of such concern.

It may be, therefore, worthwhile to first rearrange (by transfer gift or in any other manner) the shareholding pattern or profit sharing ratio to bring it below 20% and then grant a loan or advance to a concern or a company. However, other aspects of rearrangement like capital gain tax, etc. will have to be kept in mind.

As per Explanation 3(a) to section 2(22)"concern" means a Hindu undivided family, or a firm or an association of persons or a body of individuals or a company.

Other Points

Whether interest paid on loan which is treated as deemed dividend will be admissible as a deduction under section 57(iii)? Section 57(iii) allows a deduction for any expenditure (not being capital expenditure) laid out or expended wholly and exclusively for the purpose of making or earning such income. In Nandlal Kanoria v. CIT [1980] 122 ITR 405(Cal.) the Calcutta High

court held that interest paid on loan treated as deemed dividend under section 2(22)(e) is not admissible as a deduction under section 57(iii).
Whether deduction u/s 80-L or 80-M is available for deemed dividend? Deemed dividends, like normal dividends, are eligible for deductions under section 80L or section 80M . However, from the assessment year 1998-99, deductions under sections 80L and 80M are not available in view of amendment/omission of the relevant section.

Some recent judgements reducing the rigours of section 2(22)(e)

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

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

- In ITO vs. M/s Sree Ramkrishna Traders, ITA No. 848/K/2007, order dated 17.03.2008, a case before ITAT, "D" Bench, Kolkata, the facts were that the assessee received advances from "C" Ltd., a company wherein partners of the assessee- firm had substantial interest. The advances amounted to Rs 1.82 crores as on 31.03.2002 and the accumulated profit as on 31.03.2003 amounted to Rs 70,93,836/-. The A.O treated the advance amount as "deemed dividend" in AY 2003-04. The Tribunal confirmed the CIT(A)'s finding that the loans and advances of Rs 1.82 crore which were received in the A.Y 2002-03 are deemed to have reduced the accumulated profit for the purpose of section 2(22)(e), thus, the same cannot be treated as "deemed dividend" in the A.Y 2003-04.

- In CIT vs. Raj Kumar [318 ITR 462 (Del.)] , the assessee was in the business of manufacturing customized kitchen equipments . He was also the managing director and held nearly 65% of the paid up share capital of a company C. A substantial part of the business of the assessee, was obtained through C. For this purpose, C could pass on the advance received from its customers to the assessee to execute the job work entrusted to

the assessee. The Assessing Officer held that the advance money received by the assessee is in the nature of the loan given by C to the assessee and accordingly is deemed dividend within the meaning of the provisions of Section 2(22)(e) of the Income Tax Act, 1961. He therefore made the addition by treating the advance money as the deemed dividend income of the assessee. The Tribunal deleted the addition.

On appeal by the Revenue, the Delhi High Court upheld the decision of the Tribunal and held as under :

"(i) The word 'advance' has to be read in conjunction with the word 'loan'. Usually attributes of a loan are that it involves the positive act of lending, coupled with acceptance by the other side of the money as loan: it generally carries interest and there is an obligation of repayment. 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 the word 'loan' may or may not include the obligation of repayment. If it does, then it would be a loan.

(ii) 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 advances which are in the nature of money transacted to give effect to a commercial transaction would not fall within the ambit of the provisions of S. 2(22)(e) of the Act.

(iii) The trade advance given to the assessee by C could not be treated as deemed dividend u/s 2(22)(e) of the Act ."

- In ACIT vs. Bhaumik Colour Pvt. Ltd. [313 ITR 146 (Mumbai, SB)] , it was held that deemed dividend u/s 2(22)(e) can be assessed only in the hands of a shareholder of the lender company and not in the hands of any other person.

- In Rekha Modi vs. ITO [(2007) 13 SOT 512 (Delhi)] , the assessee was an individual holding more than 10 per cent shares of a closely held company. The assessee had received a loan from this company. In the assessment proceedings, assessee submits that lending of money was a substantial part of the business of the company. The assessing officer ("the AO") based on the Memorandum of Association and the factual data for three years immediately preceding previous year held that the company was engaged in the business of exports and not business of money lending hence, treated the loan as deemed dividend. The first Appellate Authority upheld the action taken by the AO. On further appeal, the tribunal after comparing income from money lending with the total income of the company on gross as well as net basis and also after comparing the turnover of loan funds to total funds of the company – the ratios of which were below 20 per cent, held as under :

"*It is thus clear that looking into the facts and figures of the said company for the year under consideration from any angle and even going by the definition given in Explanation 3(b) relied upon by the learned counsel for the assesee, the money-lending business constituted less than 20 per cent of the total business of the said company and it, therefore, cannot be said that the lending of money was a substantial part of the business of the said company.*"

As can be seen, the tribunal has applied the definition of the expression" substantial" given in Explanation 3(b) for interpreting the same expression used in them (ii) of the exceptions to section 2(22)(e) of the Act. In the above decision, if the ratio of money lending business would have been 20 per cent or more , the Tribunal could have decided the issue in favour of the assesee by holding the section 2(22)(e) is not applicable, as the company is covered by item (ii) of the exceptions to that section 2(22)(e) i.e. business of money lending.