

Deemed Dividend u/s 2(22)(e) : A Comprehensive Study

DEEMED DIVIDEND U/s 2(22)(e) OF THE INCOME TAX ACT, 1961 : A Comprehensive Study

Scope of Section 2(22)(e)::

Type of Company : a Closely Held Company i.e., a Company in which the public is not substantially interested.

[See Note 5 - Definition of "Company in which the public is substantially interested"]

Nature of Payments : (i) Any payment by way of advance or loan; OR [See Note 6]

Exception: Loan or advance is granted [See Note 12]

a. in the ordinary course of its business and [See Note 10]

b. lending of money is a substantial part of the company's business. (See Section 2(22)(e) (ii)) [See Note 11]

(ii) Any payment, on behalf of, or for the individual benefit of such Shareholder. [See Note 7]

To Person's Covered : (i) Any shareholder who is a beneficial owner of 10% or more of Voting power of the Company (but the shares shall not be entitled to a fixed rate of dividend, whether with or without a right to participate in profits); Or [See Note 9]

(ii) (a) To a concern (includes {HUF, Firm, AOP or BOI, Company}) in which such shareholder is a partner or a member , AND;

(b) has substantial interest (when entitled to 20% or more of the income of such concern).

Author's Comments: The condition in clause (ii) (a) and (b) are 'cumulative'

Amount : of Advance or Loan.

Subject to maximum of **Accumulated Profits** (up to date of payment of Dividend). [See Note 8]

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A loan not covered by Accumulated Profits is not deemed to be dividend.

Accrual : In the “previous year” in which the payment was made. {Section 8(a)} [See Note 13]

Key Points To Be Noted::

1. Purpose of Section 2(22)(e)

Section 2(22)(e) of the Income Tax Act, 1961 *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 companies pay or distribute, what would legitimately be dividend in the hands of shareholders, money in the form of advance or loan.*

- Read in CIT v. Raj Kumar (2009) 181 Taxmann 155 (Delhi).

2. Non-Applicability of Dividend Distribution Tax u/s 115-O of I. T. Act, 1961 & Exemption u/s 10(32):

Provisions of Corporate Dividend Tax (Section 115-O) are not attracted in case of “Deemed Dividend” & as a consequence thereof, exemption u/s 10(32) is not available. (*Explanation to Chapter XII-D of the I. T. Act, 1961 – appears below Section 115-Q*)

3. Heads of Income & Rate of Tax:

Deemed Dividend is taxed under the head Income from Other Sources.

No special rate of tax is applicable to deemed dividend and it is taxed as income chargeable to tax at normal rates – slab rates in case of individuals & HUF's.

4. Set-Off To Avoid Double Taxation:

Subsequently, when the company declares dividend, & any such dividend is set-off against the advance, the dividend so adjusted against the advance (which has been deemed as dividend), will not be again treated as dividend. (See Section 2(22)(e) (iii))

5. Company in which public is substantially interested (See Section 2(18)) includes:

- a company owned by the Government or the RBI or more than forty percent of the shares are owned by Government or the RBI or a corporation owned by the RBI.
- a company registered under section 25 of the Companies Act, 1956.
- a company not having share capital and declared by the Board to be such company

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- d. Mutual Benefit Finance Company – business of acceptance of deposits from members and notified by the Central Government u/s 620 of the Companies Act, 1956.
- e. a company, whose more than 50% Equity Shares (not being Preference Shares) held by one or more Co-operative Societies throughout the previous year.
- f. a company not being a Private Company as defined in the Companies Act, 1956, whose Equity Shares were listed on the 31 March of the previous year in a Recognised Stock Exchange.
- g. a 'Government Company' not being a 'Private Company' (both terms being defined in the Companies Act, 1956).

6. What does not constitute a Loan or Advance?

The term "Loan or Advance" has not been defined under the Income Tax Act, 1961. Basically, the Loan or Advance must create the relationship of 'lender' and 'borrower' and not merely that of a 'debtor' and 'creditor'. A relationship of 'lender' and 'borrower' will generally be created when there is an outgoing or flow of money from the company to the shareholder.

- a. In the matter of [Dr. Freddie Ardeshir Mehta v. Union of India \[1991\] 70 Comp. Cas. 210 \(Bom\)](#), Held:

Loan means an advance of money, upon the understanding that it shall be paid back, and it may or may not carry interest. A credit sale resulting in a Book Debt does not amount to a loan.

- Inference -->
- a. Therefore, only an actual payment of money by the company, upon the understanding of its repayment, shall be termed as loan.
 - b. Any interest on the loan, resulting in an increase in the total amount due, shall not be considered a loan for the purpose of Section 2(22)(e).

Author's Comments: The above decision has been rendered in a Case pertaining to the Companies Act, 1956. The phrase "Loan or advance" has neither been defined under the Income Tax Act, 1961 nor the Companies Act, 1956. However, the cardinal issue in the instant case was the meaning of the term 'Loan or Advance', being an issue similar in context, and has been relied on by the Author.

- b. In the matter of [CIT v. Raj Kumar \(2009\) 181 Taxmann 155 \(Delhi\)](#), Held:

The usual attributes of a loan are that it involves positive act of lending coupled with the acceptance by the other side of the money as loan – it generally carries interest and there is an obligation of repayment.

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The term 'advance' is of wide import & has undoubtedly more than one meaning, depending on the context in which it is used. In its widest meaning, the term 'advance' may or may not include lending or the obligation of repayment.

The Delhi High Court applied the rule of construction of *noscitur a sociis* – “the meaning of the word can be gathered from the context” or “by the company which it keeps.”

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 it give effect to a commercial transactions would not fall within the ambit of the provisions of Section 2(22)(e) of the Act.

followed in: [CIT v. Creative Dyeing & Printing Mills Pvt. Ltd.](#)

- c. You may also refer to [CIT v. G. Venkataraman \[1975\] 101 ITR 673 \(Mad.\)](#).

Mere creation of debtor-creditor relationship is not enough - There should be an actual cash advance or loan from the company to the assessee and the mere creation of a debtor and creditor relationship between the company and the assessee will not be enough. **There should be an outgoing or flow of money from the company to the shareholder.**

- d. A similar view has been expressed in [Bombay Steam Navigation Company P. Ltd. v. CIT \(1965\) 56 ITR 52 \(SC\)](#)

“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.”

- e. **Inter-corporate deposits** : shall not be treated as deemed dividend u/s 2(22)(e) of the I. T. Act, 1961. – per [Bombay Oil Industries Ltd. v. DCIT \(2009\) 28 SOT 383 \(Mum\)](#)
- f. **Interest Provision** : shall not be treated as deemed dividend u/s 2(22)(e) of the I. T. Act, per [CIT, Panaji – Goa v. Parle Products Ltd. \(2011\) 196 Taxmann 62 \(Bom.\)](#).

7. **Payments to Relatives of Shareholders or to Third Parties who advance Loans to Shareholder**

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Generally speaking – Payments to relatives of shareholders or to Third parties are not covered u/s 2(22)(e).

However, in the *peculiar* facts & circumstances of the case, payments to relatives of Shareholders or to Third parties who, in turn use these fund to advance loans to shareholders will be covered under Section 2(22)(e) as 'Deemed Dividend'. This is because, in addition to “Loans or Advance”, deemed dividend also includes – “Any payment, on behalf of, or for the individual benefit of such Shareholder.”

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Illustrations

7.1.a. In the matter of [CIT v. L. Alagusundaram Chettiar \[1977\] 109 ITR 508 \(Mad.\)](#),

Facts A managing director of a company, whenever he needed money used to ask an employee to take a loan from the company and the company would pass it on to the employee even without executing any pronote. The employee advanced the loan to the assessee almost immediately and *in toto*.

Held 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.

7.1.b. In the matter of [Nandlal Kanoria v. CIT \[1980\] 122 ITR 405 \(Cal.\)](#), Held

Facts 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 September 2, 1968, respectively. Y had made the loans of Rs. 75,000 to the assessee out of loans received by Y from X on the same date. Further, Y had made the loans of Rs. 2,00,000 to the assessee out of loans received by Y from X and another source on the same date.

Held this amount of Rs. 75,000 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.

8. What is “Accumulated Profits”?

a. In the matter of [P. K. Badiani v. CIT \(1976\) 105 ITR 642 \(SC\)](#), Held:

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..

Further, Capitalisation of accumulated profits prior to such payment of loan or advance, cannot be deemed as dividend u/s 2(22)(e).

Share Premium is not accumulated profits.

b. Share forfeiture receipts – are not accumulated profits ([Jai Kishan Dadlam \(2005\) 4 SOT 138 \(Mum\)](#))

c. In the matter of [Navnitlal C. Jhaveri v. CIT \(1971\) 80 ITR 582 \(Bom\)](#), Held:

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.

d. Further, in the matter of [CIT v. G. Narasimhan \(1979\) 118 ITR 60 \(Mad\)](#), Held:

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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, irrespective of the fact that no adjustment is made in the books of accounts.**

9. What is a “Shareholder” for the purpose of Section 2(22)(e)?

*** This is point requires addition***

10. Whether a Loan or Advance is in the “Ordinary Course of Business”?

In determination thereof, the following points have to be considered:

- (a) Whether the company is a Non-Banking Financial Company (NBFC) registered with the RBI?
- (b) Whether any Loan or Advance made to any person(s), other than Shareholder(s), Director(s) or their Relatives?
- (c) Terms ~ Rate of interest & Terms of Repayment – is it same as it is given to other borrowers.

11. What constitutes “Substantial part of the company’s business”?

The term “substantial part of the company’s business” has not been defined under the Income Tax Act. However, the Tribunal has in Mrs. Rekha Modi v. ITO (2007) (13 SOT 512), held that the ratio of money lending business should be 20% or more to be considered “substantial part of the company’s business”.

Further, for determination of the fact whether the company was engaged in money lending business, factual position for the relevant ‘previous year’ (i.e., the year in which the loan or advance was made) should be considered.

12. Onus is on the Assessee to prove these facts -i.e., the Loan or Advance is in the “Ordinary Course of Business” and Lending of money constitutes substantial part of the company’s business. {See [Walchand & co. Ltd. V. CIT, \(1975\) 100 ITR 598 \(Bom\)](#)}

13. Accrual of “Deemed Dividend”

- a. “Deemed Dividend” accrues in the ‘previous year’ in which the payment was made. (Section 8(a)).

Therefore, only payment(s) made during the “current year” is covered & any outstanding balances / interest on loans are to be ignored. The assessing office may reopen assessment proceedings u/s 147, to bring “deemed dividend” escaping assessment to tax for the preceding assessment years.

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Any loan(s) which were outstanding beyond the limitation period will be exempt from tax. The limitation period is period for which the assessing officer cannot issue Notice u/s 147 for reassessment of income.

- b. In **CIT, Panaji – Goa v. Parle Products Ltd. (2011) 196 Taxmann 62 (Bom.)**, HELD:

Only that amount of loans & advances, which was **actually received** by the assessee by way of loan or advance during the relevant previous year, could be treated as income by way of 'deemed dividend' and the carried forward balance of the loan of the previous year could not be treated as deemed dividend.

14. Deduction of Tax at Source u/s 194 -

The principal officer of an 'Indian Company or a foreign Company which has made arrangement for payment of dividends in India' is liable to deduct income tax u/s 194 at the rate in force, before making any payment of any sum deemed to be dividend u/s 2(22)(e) of the I. T. Act, 1961.

Further, the company may be liable to penalty u/s 271C(1)(a) of an amount equal to the 'amount of tax which such person' failed to deduct.

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

Section 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-section (1) of section 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 Non-resident Shareholder subject to DTAA relief.

16. Deemed Dividend in case of Loan or Advance by a Foreign Company to a Resident Shareholder

Section 2(22)(e) does not distinguish between an Indian or a Foreign Company.

Sum paid by a Foreign Company to a resident shareholder has been held as deemed dividend (See [Gautam Sarabhai v. CIT \(1964\) 52 ITR 921 \(GUJ.\)](#))

17. 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 Income Tax Rules, 1962 for reporting of 'Deemed Dividend' paid by a Company. However, 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 as per para 7 (*supra*) Tax is required to be deducted by the principal officer of an Indian Company u/s 194,

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the Auditor is obliged to report of Non-deduction of TDS u/s 194 in the Audit Report Form No. 3CD.