



1. Intention of behind introduction of Section 2(22)(e)

Section 2(22)(e) of the Income Tax Act, 1961 bring within the tax on 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. History of Section 2(22)(e) of the Income Tax Act, 1961.

- a) Section 2(6A) of the Indian Income Tax Act, 1922 corresponding to Section 2(22) of the Income Tax Act, 1961 was first introduced by the Indian Income Tax (Amendment) Act 1939.
- b) Clause (e) was added to Section 2(6A) of the Indian Income Tax Act, 1922 corresponding to Section 2(22)(e) of the Income Tax Act, 1961 by the Finance Act, 1955. By virtue of this amendment, for the first time, the fiction of treating loans or advances to shareholders as dividend was first introduced in the Income Tax Law.
- c) The provisions of Section 2(6A) of the Indian Income Tax Act, 1922 were incorporated in Section 2(22) of the Income Tax Act, 1961 without any amendments.
- d) The first and only amendment to Section 2(22)(e) was made by Finance Act, 1987 (w.e.f. 01-04-1988) wherein the phrase "Shareholder who has substantial interest" then appearing was replaced by the phrase "a Shareholder who is a beneficial owner of shares holding not less than 10% of the voting power".
- e) The constitutional validity of the provisions of Section 2(22)(e) was upheld by the Supreme Court in the matter of Navnitlal C. Jhaveri v K K Sen, AAC [1965] 56 ITR 198 (SC).

3. Definition of Sec 2(22)(e) of the Income Tax Act as per Bare Act.

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

- i) *A shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent of the voting power,*
- ii) *or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern)]*
- iii) *or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits;*

Definition of Dividend:

- i) 'Dividend', in ordinary course the sum paid to or received by a shareholder proportionate to his shareholding in a company out of the total sum of profit distributed.
- ii) However, The definition of Dividend u/s 2(22) is include certain distribution / payments by the company to its shareholders, namely :-
 - a) distribution entails the release of all or any part of the assets of the company ;
 - b) distribution of debentures, debenture-stock or deposit certificates in any form, whether with or without interest ;
 - c) distribution by a company on its liquidation ;
 - d) distribution by a company on the reduction of its capital ;



- e) Payment by a Closely Held Company by way of advance or loan to a shareholder who is a beneficial owner of shares holding not less than 10% of the voting power.

There are following conditions incorporate in sec 2(22)(e).

i. Types of company

Definition of 'a company in which the public is substantially interested', a 'closely held company' will include:-

- a) A Private Company as defined in the Companies Act, 1956 ; and
- b) A Company not being a Private Company as defined in the Companies Act, 1956 and whose Equity Share are not listed on the 31 March of the previous year in a Recognized Stock Exchange.
- However 'closely-held company' is not defined under the Income Tax Act, 1961 but it means a 'company in which the public is not substantially interested'.
- Section 2(18) of the Income Tax Act, 1961 defines 'a company in which the public is not substantially interested' to include :-
 - o 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.
 - o A company registered under section 25 of the Companies Act, 1956.
 - o A company not having share capital and declared by the Board to be such company
 - o 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.
 - o A company, whose more than 50% Equity Shares (not being Preference Shares) held by one or more Co-operative Societies throughout the previous year.
 - o A company not being a Private Company as defined in the Companies Act, 1956, who's Equity Shares were listed on the 31 March of the previous year in a Recognized Stock Exchange.
 - o A 'Government Company' not being a 'Private Company' (both terms being defined in the Companies Act, 1956).

Query:- Whether Sec 2(22)(e) applicable to foreign Companies.

- Section 2(22)(e) does not distinguish between an Indian or a Foreign Company.
- Section 2(17) defines "company" to include a body corporate incorporated by or under the laws of a country outside India.
- Sum paid by a Foreign Company to a resident shareholder has been held as dividend - See Gautam Sarabhai v. CIT (1964) 52 ITR 921 (GUJ.)
- It is further pertinent to note that a Recognized Stock Exchange has been defined in the Income Tax Act, 1961 to mean a stock exchange recognized as such by the Central Government under section 2(f) of the Securities Contracts Regulation Act, 1957 (SCRA). Further, at present only stock exchanges operating in India have been recognized by the Central Government. Accordingly, as a corollary, a Stock Exchange outside India is not Recognized by the Central Government and a Foreign Company listed outside India or also an Indian Company listed outside India (and Not listed in India on the 31 March of the previous year) will be a 'Closely Held Company' for the purpose of Section 2(22)(e).



2. Nature of Payments.

- Any payment by way of advance or loan; OR
- Any payment, on behalf of, or for the individual benefit of such Shareholder.

Definition of 'Loan' or 'Advance':-

- Term of Loan or Advance has not been defined under the Income Tax Act, 1961.
- However '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.
- Held in the case of G.R. Govinda Rajolu Naidu v CIT (1973) 90 ITR 13 (Mad), There should be an outgoing or flow of money from the company to the shareholder; A notional payment by way of book entries will not be included. on the facts of the case, the amounts due by the assessee to the company towards the first and second call monies on the shares held by it in the company – Not Deemed Dividend u/s 2(6A)(e) of the Indian Income Tax Act, 1922.
- Advances mean something which is due to a person but which is paid to him ahead of the time when it is due to be paid. - CIT v Srinivasan (K.) (1963) 50 ITR 788 (Mad).

Illustrations of Loans or Advances

Particulars	Excluded from Loans or Advances
Advance in Kind	Included
Trade Advance	Included
Imprest Balance with Directors	Exclude
Inter-Corporate Deposit	Excluded
Trade Advance	Excluded

Examples of Advances

- Held in the case of **CIT v P.K. Abubucker (2003) 259 ITR 507 (Mad)**. Company had advanced to a shareholder a sum for construction of a building to be taken on lease, and the amount so advanced was to be adjusted against future rent. Such advance was treated as Deemed Dividend.
- Held in the case of **Dr. Shiv Kant Mishra v Dy CIT (2009) 118 ITD 347 (Luck)**, an MoU was entered into between the assessee and the company whereby the company advanced money to the assessee for purchase of land and as per term assessee was to transfer by way of lease a portion of land in favour of the company. Further, the assessee constructed a residential building for his personal use on the said land.

Tribunal held that neither the business of the company was to carry on construction or deal in real estate nor did the assessee's case fall in the exception provided in section 2(22). The Tribunal held that the MoU between the company and the assessee was a colourable device adopted for transfer of accumulated profits as loan for an indefinite period.

Accordingly, the inclusion of such amount as deemed dividend in the hands of the assessee was upheld by the Tribunal. Thus, the decision went in favour of the revenue.



EXCLUSIONS FOR LOANS OR ADVANCE IN THE ORDINARY COURSE OF BUSINESS AND WHERE LENDING OF MONEY IS A SUBSTANTIAL PART OF BUSINESS

Clause (ii) of Section 2(22) – "... but "dividend" does not include –

- 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; ... "so two condition are required
- i) held in the case of CIT v V.S. Sivasubramaniam (1998) 231 ITR 656 (Mad)] Advance or loan made to shareholder is in the "ordinary course of business"; 'Ordinary course of business' shall mean that the loan or advance should be given to such shareholder at the same rate and terms as it is given to other borrowers.
Held in the case of Jhamu V. Sughend v DCIT (2006) 284 ITR (AT) 82 (Mum). Merely on the basis of company did not have any money lending license, lending of money will not be treated as deemed dividend, if the assessee was lending money in the ordinary course of its business. –
- ii) Lending of money is a substantial part of the business of the company; "substantial part of business of the company" is not defined under the Income Tax Act, 1961
In the case of CIT v. Parle Plastics Ltd. (2011) 196 Taxmann 62 (Bom.), Held that "substantial" as "A word of no fixed meaning, it is an unsatisfactory medium for carrying the idea of some ascertainable proportion of the whole".
"substantial" does not mean "major"
Various factors to be looked into to determine whether the business is substantial or not, namely :- Turnover, Profits, Capital Employed, Human Resources. d. Any business which the company does not regard as small, trivial, or inconsequential as compared to the whole of the business is substantial business.

PAYMENTS ON BEHALF OF OR FOR THE INDIVIDUAL BENEFIT OF SUCH SHAREHOLDER – EXAMPLES

1. **In the case of** CIT v. L. Alagusundaram Chettiar[1977] 109 ITR 508 (Mad.), A managing director of a company, whenever he (co) 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 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.
2. **in the case of** Nandlal Kanoria v. CIT [1980] 122 ITR 405 (Cal.), 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 that the mount 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.



III. TO PERSONS' 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
- ii) To a concern (includes {HUF, Firm, AOP or BOI, Company}) in which such shareholder is a partner or a member , AND;
has substantial interest (when entitled to 20% or more of the income of such concern).

Query: - What is the meaning of Share holder? Is there any difference between Share holder and Beneficiary?

Answer: - Shareholder means a Registered Shareholder whose name appears in the Register of Member u/s 150 of The Companies Act, 1956 & Beneficiary means whose name does not appear in the Register of Member u/s 150 but has a beneficial interest in such shares by virtue of Declarations furnished u/s 187-C of The Companies Act, 1956.

Whereas the word shareholder used in section 2(22)(e) can only mean a registered shareholder. It is difficult to see how a beneficial owner of shares whose name does not appear in the register of shareholders of the company can be said to be a "shareholder". He may be beneficially entitled to the shares but he is certainly not a "shareholder".
- Rameshwarlal Sanwaram v CIT (1980) 122 ITR 1 (SC)

In case of non-corporate entities, such as Trusts (Public Charitable or Private), Hindu Undivided Family, Partnership Firms, etc the shares are held in the name of Trustees, Karta (Manager) or the Partner, respectively, whereas the beneficial owner of the Shares is the respective Entity. Section 2(22)(e) applies only in case The beneficiary and the shareholder are the same person and not applicable in case The beneficiary is not the Registered Shareholder ; or The Registered Shareholder is not the beneficiary. Similar views have been expressed in CIT v. C P Sarathy Mudaliar (1972) 83 ITR 170(SC) ; ACIT v. Bhaumick Color (P) Ltd. (2009) 118 ITD 1 (MUM.) (SB) ; CIT v. National Travel Services (2011) 202 Taxmann 327 (Delhi)

Query: - whether Sec 2(22)(e) is include Non-Resident Shareholder?

Answer:-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) subsection (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.

Some Basic Points.

- Beneficial owner of the shareholder means who is holding 10% or more voting power[other then preference share holder] **on the date of Loan & Advance**
- A person shall be deemed to have a substantial interest in a concern:-
Other than a company if he is, beneficially entitled to not less than 20% **income** of such concern.
In the case of a company, if he beneficially holds at least 20% **equity capital** of the company.
At any time during the previous year.
- If the loan or advance is given to a concern (HUF, Company, Firm, AOP or BOI) in which the shareholder and beneficiary has a substantial interest, then the deemed dividend u/s 2(22)(e) will be included in the Total Income of THE SHAREHOLDER and NOT THE CONCERN. Held in the case of ACIT v. Bhaumick Color (P) Ltd. (2009) 118 ITD 1 (MUM.) (SB) ; CIT v Universal Medical Pvt. Ltd. (2010) 190 Taxman 144 (Bom) ; CIT v. Ankitech (P) Ltd. (2011) 11 taxmann.com 100 (Delhi) ;



IV. AMOUNT

Query:- What amount is consider is a Deemed dividend under Sec 2(22)(e)

Answer:- Amount of Loan & Advance and Accumulate profit whichever is lower.

Query:- What are Accumulated Profits?

Answer:- Held in the case of P. K. Badiani v. CIT (1976) 105 ITR 642 (SC), 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.

Query:- For allowance of Depreciation, what rate is applicable?

Answer:- held in the case of Navnitlal C. Jhaveri v. CIT[1971] 80 ITR 582(Bom), tha, 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.

Query :- Is Profit (Loss) of Current Year included in “Accumulated Profits”?

Answer:- “accumulated profits” shall include all profits of the company up to the date of distribution or payment referred to in sub-clauses (a), (b), (d) & (e) of Sec 2(22)

However, the Supreme Court has held, “The profit accruing during the year cannot be considered as an accumulated profit for the purpose of section 2(22). When there are a series of payments / repayments of loan or advance to the shareholder during the particular year and If current year profits were included for computation of accumulated profits, then the profit will have to be determined at every point where a payment is made.

Examples of Accumulated Profits.

Particulars	Included/ Excluded from Accumulated Profits
General Reserve	Included
Profits generated from Exempt Income or Agricultural Income	Included
Capital Gains[other then Exempted]	Included
Investment Allowance Reserve	Included
Development Rebate Reserve	Included
Securities Premium	Excluded
Share Forfeiture Receipts	Excluded
Additions made by AO	Excluded
Provision for Tax and Dividend	Excluded

Some Basic Points.

- “Deemed Dividend” accrues in the ‘previous year’ in which the payment was made. Therefore, only payment(s) made during the “current year” is covered & any outstanding balances / interest on loans are to be ignored.
- The assessing officer may reopen assessment proceedings u/s 147, to bring “deemed dividend” escaping assessment to tax for the preceding assessment years.
- Any loan(s) which were outstanding beyond the limitation period cannot be assessed to Income-tax. The limitation period is period for which the assessing sofficer cannot issue Notice u/s 147 for reassessment of income.
- **COMPLIANCES BY THE ‘CLOSELY HELD COMPANY’**
 - 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 sSection 115-Q)



- **TDS under Section 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.
- **Consequences of Failure to Deduct Tax under Section 194**
No disallowance u/s 40(ia) of the Income Tax Act, 1961
- 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 C2 (supra) 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.
- Subsequently, when the company declares dividend, & any such dividend is set-off against the advance, then the dividend so adjusted against the advance (which has been deemed as dividend), will not be again treated as dividend. (See Section 2(22)(iii)).
- **COMPLIANCES BY THE RECEIPT SHAREHOLDER**
 - 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.
 - The burden is on the Revenue to prove that the case is falling within the mischief of the deeming provision u/s 2(22)(e) of the Income Tax Act, 1961. - Subrata Roy Sahara v. ACIT Central Circle III, Lucknow (2007) 109 ITD 1 (Luck) (TM)
However, if the assessee is claiming any exception, say Loan or advance is in due course of the business, and lending is substantial part of the business ; or
Loan or advance is set-off against dividend declared subsequently; then the burden is on the assessee to prove that the case is falling within the exception to the deeming provision u/s 2(22)(e) of the Income Tax Act, 1961. -Walchand & Co. Ltd. v. CIT (1975) 100 ITR 598 (Bom).