Is Deemed dividend, Dividend?

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Recently, the Mumbai Income Tax Appellate Tribunal (the "Tribunal"), inter alia, held that an Inter-Corporate Deposit ("ICD") cannot be equated with a loan and therefore does not come under the purview of "deemed dividend" as stipulated u/s 2(22)(e) of the Income Tax Act, 1961 (the "Tax Act").[1]

FACTS

KIIC Investment Company (the "Taxpayer"), an entity incorporated in Mauritius held 99.99% and 99.88% shares in two companies, viz., M/s Portescap India Private Limited ("Portescap") and M/s Videojet Technologies India Private Limited ("Videojet"), respectively. Further, the Taxpayer held 100% shares in M/s Gilbarco Veeder Root (India) Pvt. Ltd. ("GVR") and M/s DHR Holding India Pvt. Ltd. ("DHR").

FY 2008-09

Portescap advanced certain sum of money to Videojet during Financial Year ("FY") 2008-09 under a deposit agreement (the "Agreement"). The Assessing Officer ("AO") initiated proceedings u/s 147 of the Tax Act[2] against the Taxpayer stating that since the Taxpayer was a common shareholder in the above two companies, the said amount should be taxable in the Taxpayer's hands as deemed dividend as per section 2(22)(e) of the Tax Act.

FY 2009 - 10

During FY 2009-10, Portescap also advanced certain amounts to GVR and DHR. In relation to the amount given to GVR, the AO held the Taxpayer liable u/s 2(22)(e) of the Tax Act on a protective basis since such amount had already been taxed in the hands of GVR on substantive basis. However, with respect to the amount given to DHR, the Taxpayer was held liable on substantive basis.

TAXPAYER'S ARGUMENTS

FY 2008-09

The Taxpayer contended that re-opening of the assessment was not valid since the said amount had already been taxed by the AO u/s 2(22)(e) of the Tax Act in the hands of Videojet on substantive basis and in the hands of Portescap on protective basis.

The Taxpayer further highlighted certain distinctions between a deposit and a loan and contended that since an ICD is different from a loan, it should not be taxable as deemed dividend.

As an arguendo, the Taxpayer submitted that deemed dividend should be taxable under Article 22 (Other Income) of the India-Mauritius Tax Treaty (the "Treaty")[3], whereby such income should only be taxable in Mauritius.

However, in case the income does not fall under Article 22(1) of the Treaty, then it should be construed to fall under Article 10 of the Treaty and therefore, the said amount should be taxable at a lower rate of 5%.

FY 2009-10

The Taxpayer contended that when the amounts were advanced by Portescap to GVR, the Taxpayer was not a shareholder

of GVR and therefore, the income should not be taxable in the hands of the Taxpayer u/s 2(22)(e) of the Tax Act even if it is to be treated as a loan or advance.

REVENUE'S ARGUMENTS

FY 2008-09

The revenue contended that since the Taxpayer was a registered shareholder of Portescap and Videojet with accumulated profits during the FY 2008-09, the sum advanced to Videojet should be taxable u/s 2(22)(e) of the Tax Act.

FY 2009-10

The revenue contended that when the amounts were advanced to GVR, it (GVR) was a step-down subsidiary of the Taxpayer and hence the said sum is liable to be taxed as deemed dividend. .

RULING

FY 2008-09

The Tribunal held that since the AO had already assessed the deposit u/s 143(3) of the Tax Act[4] as deemed dividend in the hands of Videojet (substantive basis) and Portescap (protective basis), the initiation of proceedings u/s 147 of the Tax Act was impermissible.[5]

The Tribunal after having perused the board resolution, audited financial statements, copy of the deposit receipt and the Agreement made certain observations, such as Portescap had surplus funds and the transaction was initiated by Portescap; funds were to be used for purchase of fixed assets, improving Videojet's commercial distribution network and meeting other working capital requirements; there was no pre-determined repayment schedule unlike a loan agreement; Portescap was entitled to ask for immediate payment in certain cases, amongst others.

Additionally, the Tribunal rightly concluded that the fiction of section 2(22)(e) of the Tax Act does not apply to ICDs and applies only to loans and advances.[6] Further, with respect to the scope of "dividend" under the Treaty, the Tribunal held that dividend under the Treaty should include deemed dividend as well. Consequently, the dividend should be taxable at the rate of 5% as provided under Article 10 of the Treaty.

FY 2009-10

The Tribunal held that since (i) the Taxpayer was not the beneficial shareholder of GVR at the time of advancement of the amount, and (ii) the amount was not given for the individual benefit of the Taxpayer, the said amount should not be taxable as deemed dividend. .

ANALYSIS

The provision for taxation of deemed dividend was introduced u/s 2(6A)(e) of the Income Tax Act, 1922. The legislative intent behind introduction of such a deeming fiction was to bring under the purview of taxation the accumulated profits which were distributed by closely held companies[7] to its shareholders in the form of loans or advances in order to enable its shareholders to avoid payment of tax on the amount received, which would legitimately constitute dividend in their hands.[8]

In the present case, as regards the scope of the term "dividend" present in the Treaty, the Tribunal observed that "dividend" consists of three features, viz., (i) income from shares; (ii) income from other rights, not being debt claims, participating in profits; and (iii) income from corporate rights which is subjected to same taxation treatment as income from shares by the laws of contracting state of which the company making the distribution is a resident of. As per the Tribunal, deemed dividend u/s 2(22)(e) of the Tax Act gets covered under the third facet stated above and hence should be treated as "dividend" under the Treaty.

However, ITAT Delhi in the case of Rajiv Makhija v. DDIT[9] expressed a contrary opinion while analyzing "dividend" as used under the India-Canada tax treaty, and held that the language under Article 10 of the treaty does not include "deemed dividend" and hence should not be chargeable to tax.

To further analyze the above, we may also take note of the cases wherein the courts / tribunals assessed whether "deemed dividend" u/s 2(22)(e) falls under the dividend in its ordinary connotation. The Hon'ble Calcutta High Court in CIT v. Jamnadas Srinivas (P) Ltd.[10] stated that "deemed dividend" u/s 2(22)(e) of the Tax Act arises out of "payment" and not

"distribution" as in the case of a dividend distributed by a company to its shareholders, and therefore, such deemed dividend should not be considered as a dividend. Similarly, apex court in Punjab Distilling Industries Ltd v. CIT[11] observed that the dividend stipulated under sub-clauses (a) to (d) of section 2(22) of the Tax Act are a function of distribution, whereas dividend under sub-clause (e) relates to payment and thus "deemed dividend" is different from dividend. However, on the contrary, in CIT v. Mysodet (P) Ltd.[12], the apex court has observed that dividend, wherever it occurs under the Tax Act, should include deemed dividend within its ambit.

In view of the above, the determination as to whether "deemed dividend" falls under "Dividend" or "Other Income" under a tax treaty may be done on a case by case basis, also depending upon the definition of dividend as stipulated under the respective treaty.

It is important to note that the deeming fiction is intended to enlarge the meaning of a particular word, which would thereafter, cover matters which otherwise may or may not fall within the present provision[13] and hence, such provisions are required to be construed strictly.[14] The revenue authorities, at times, may tend to adopt a liberal approach in the interpretation of section 2(22)(e). While the approach of the revenue authority to scrutinize every transaction involving loan or advance received by an assessee seems a step towards curbing tax evasion, it indubitably leads to overstretching the provision. The assessee, likely suffers difficulties in its transactions on two counts, firstly, due to prevailing uncertainty as to the categorization of the advance or loan received, and secondly, the liberty of the revenue to gauge through every transaction entered into by the assessee. Considering the foregoing, it becomes necessary for the companies providing and / or accepting deposits to enter into a bilateral agreement with each other clearly expounding the commercials related to, inter alia, the terms of the deposit, interest payments, repayment schedule, the purpose of giving and accepting such deposit, and the termination of the agreement.

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[1] Section 2(22)(e) of the Tax Act brings to tax as dividend in the hands of the shareholders three types of payments made by a company, viz., (i) any payment 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; (ii) any payment on behalf of a shareholder; and (iii) any payment for the individual benefit of a shareholder.

[2] Income escaping assessment.

[3] Article 22(1) of the Treaty stipulates that the income which is not dealt with in any other article of the Treaty shall be taxable only in the jurisdiction where such income arises.

[4] Scrutiny Assessment

[5] Also see DCIT v. Bullion Investments & Financial Services (P.) Ltd , [2010] 123 ITD 568 (Bang.).

[6] Also see IFB Agro Industries Ltd. v. JCIT, [2014] 63 SOT 207 (Kolkata - Trib.); Dy. CIT v. Schutz Dishman Bio-tech (P.) Ltd, [2015]

[7] Companies in which the public are not substantially interested. See Section 2(18) of the Tax Act for the meaning of "company in which the public are substantially interested".

[8] CIT v. Raj Kumar, (2009) 318 ITR 462 (Delhi).

[9] ITA No. 3148/Del/2008.

[10] 76 ITR 656, 660 (Cal).

[11] (1965) 57 ITR 1 (SC).

[12] (1999) 237 ITR 35 (SC). Also see CIT v. Narsimhan (G), (1999) 236 ITR 237 (SC).

[13] CIT v. Surat Cotton, 202 ITR 932; Caltex Oil Refining India Ltd. v. CIT, 202 ITR 375.

[14] CIT v. Khimji Menshi, 194 ITR 192; CIT v. Kaimal, 123 ITR 755; Malik v. CIT, 124 ITR 522; CIT v. Bhupender Singh Atwal, 140 ITR 928.