IN THE INCOME TAX APPELLATE TRIBUNAL
"C" BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, VICE PRESIDENT
AND SHRI INTURI RAMA RAO, ACCOUNTANT MEMBER

ITA No.1706/Bang/2017
Assessment year : 2012-13

Microfinish Valves Private Limited, B-161/162, Industrial Estate, Gokul Road, Hubli. **PAN: AABCM 2527Q**	Vs.	The Assistant Commissioner of Income Tax, Circle 2(1) Hubli.
APPELLANT		RESPONDENT

Appellant by	:	Shri S.V. Ravishankar Advocate
Respondent by	:	Dr. P.V. Pradeep Kumar, Addl.CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	13.11.2018
Date of Pronouncement	:	16.11.2018

O R D E R

Per N.V. Vasudevan Vice President

This appeal by the assessee is against the order dated 05.05.2017 of the CIT(Appeals), Hubli relating to assessment year 2012-13.

2. The first issue that arises for consideration in this appeal is with regard to the action of the revenue authorities in bringing to tax a sum of Rs.4 crores as deemed dividend u/s. 2(22)(e) of the Income-Tax Act, 1961 ["the Act"].

3. The facts with regard to the above said addition are as follows. The assessee is a company engaged in the business of manufacture of valves. The assessee borrowed a sum of Rs.4 crores from M/s. Micofinish Pumps Pvt. Ltd. (**MPPL**). The AO noticed that there were common directors in both the assessee company and MPPL and therefore the sum of Rs. 4 crores received as advance from MPPL was liable to be added as deemed dividend u/s. 2(22)(e) of the Act in the hands of the assessee company. The following table would show the common shareholding and their share holding in the Assessee company as well as MPPL:

Sl.No.	Name of the Director	Percentage of Shareholding in the Assessee company	Percentage of holding in Microfinish Pumps Pvt.Ltd.
1	Sri Tilak K. Vikamshi	24.99%	25%
2.	Sri Deepak K. Vikamshi	24.99%	25%
3.	Sri Tushar K. Vikamshi	24.99%	25%
4.	Sri Mahendra K. Vikamshi	24.99%	25%

4. The plea of the assessee before the lower authorities was it was not a shareholder in MPPL and therefore the provisions of section 2(22)(e) of the Act cannot be invoked in the hands of assessee. In other words, the contention of the assessee was that the first condition to be satisfied for invoking the provisions of section 2(22)(e) of the Act was that the assessee should be a shareholder in the company which had given loan. The other contentions put forth by the assessee was that the funds were given for the business purpose, therefore the provisions of section 2(22)(e) could not be applied. This explanation was rejected by the AO for the following reasons:-

> "9. The assessee's explanation is considered carefully, however the same is found to be not acceptable. M/s Microfinish Pumps Pvt. Ltd. is not in the business of lending of money within

the meaning of the provisions of section 2(22)(e) of the Act. Further, as per the statement of accounts, M/s Microfinish Pumps Pvt Ltd., has sufficient reserves and surplus as on 31/03/2012. The provisions of section 2(22)(e) are applicable also to the advance or loan made to a corporate entity - Sadhana Textiles Mills (P.) Ltd. v. CIT [1991) 188 ITR 318 (Born.).

10. In view of the above facts and discussion, it is confirmed that the Company. M/s Microfinish Pumps Pvt. Ltd (wherein the directors of the assessee Company have substantial interest i.e. shareholding exceeding 20%) having sufficient 'accumulated profits' as on dates of advances of Rs. 4,00,00,000/- made to the assessee-Company (wherein the directors of M/s. Microfinish Pumps Pvt. Ltd. are having substantial interest i e. shareholding exceeding 20%). Hence the said advances of Rs. 4,00,00,000/ - amounts to deemed dividend within the meaning of the provisions of section 2(22)(e) of the Act. According y the said amount of Rs. 4,00,00,0001- is assessed to tax in the hands of the assessee company."

5. On appeal by the assessee the CIT(Appeals) confirmed the order of the AO for the following reasons:-

"14. Before me the assessee has filed written submission in which it has came up with new explanation stating that Rs. 400 lakhs received is not loan or advance but it is an inter-corporate deposits received from Micro-finish Pumps Pvt. Ltd. Apart from repeating the same explanation as was done before the Assessing Officer. wi h case laws. the assessee has not added anything.

15. In view of the above findings. it is very clear that M/s. Micro-finish Trading Pvt. Ltd., (Wherein the directors of the assessee company have substantial interest i.e. shareholding exceeding 20%) has huge accumulated profits as on date of advances of Rs. 400 lakhs made to the assessee company (wherein the directors of M/s. Micro-finish Pumps Pvt. Ltd., are having substantial interest exceeding 20%). As such the said advances of Rs. 400 lakhs amounts to deemed dividend within the meaning of the provisions of sec. 2(22)(e) of the Act, and the same is rightly

brought to tax in the hands of the assessee company. **In the result, the appeal on this ground is dismissed.**"

6. Aggrieved by the order of CIT(Appeals), the assessee has preferred the present appeal before the Tribunal.

7. The grounds raised by the assessee challenging the aforesaid addition are as follows:-

"2. The learned CIT(A) was not justified in law in confirming the addition of the inter corporate deposit of Rs. 4,00,00,000/- as deemed dividend under section 2(22)(e) of the Act, in the hands of the appellant on the facts and circumstances of the case.

3. The learned CIT(A) was not justified in law in ignoring the fact that the appellant did not hold any shares in M/s Microfinish Pumps Pvt Ltd and hence was not eligible to receive any dividend and consequently provisions of section 2(22)(e) of the Act, are not applicable, on the facts and circumstances of the case.

4. The learned CIT(A) was not justified in fact in confirming the action of the assessing officer, in holding that the appellant has received a loan from M/s Microfinish Pumps Pvt Ltd, when the said receipt was an Inter Corporate Deposit on the facts and circumstances of the case.

5. The learned CIT(A) was not justified in law in holding that the directors were common in both the companies and hence the provisions of section 2(22)(e) were attracted, which is a narrow interpretation of the provisions of the Act, on the fact and circumstances of the case."

8. We have heard the submissions of the parties on ground No.5 raised by the assessee which is with regard to the action of the revenue authorities in invoking the provisions of section 2(22)(e) in a case where the assessee is not a shareholder in a company which has given the loan. On this issue, we shall first set out the provisions of Sec.2(22)(e) of the Act

which deems certain loans to be dividend and brings it to tax in the hands of the recipient of the loan. The said provisions reads thus:

> *"(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 31-5-1987, 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 per cent 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 the 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."*

Explanation-3 to Section 2(22)(e) is as follows:

> "Explanation-3: For the purpose of this clause-
>
> (a) "concern" means a Hindu Undivided Family, or a firm or an association of persons or a body of individuals or a company;
>
> (b) 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;"

9. Section 2(32) defines the expression "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.

10. An analysis of the above provisions shows that there are three limbs to Sec.2(22)(e) which are as follows:-

> "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 31-5-1987**, by way of advance or loan:
>
> First limb
>
> (a) 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 per cent of the voting power,
>
> Second limb
>
> (b) 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)
>
> Third limb
>
> (c) 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."

11. In the present appeal we are concerned with the second limb of Sec.2(22)(e) of the Act, viz., "to any concern in which such shareholder is a member or a partner and in which he has a substantial interest". The following conditions are required to be satisfied for application of the above category of payment to be regarded as Dividend. They are:-

(a) There must be a payment to a concern by a company.

(b) A person must be Shareholder of the company being a registered holder and 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**.** This is because of the expression "Such Shareholder" found in the relevant provision. This expression only refers to the shareholder referred to in the earlier part of Sec.2(22)(e) viz., a registered and a beneficial holder of shares holding 10% voting power.

(c) The very same person referred to in (b) above must also be a member or a partner in the concern holding substantial interest in the concern viz., when the concern is not a company, he must at any time during the previous year, be beneficially entitled to not less than twenty percent of the income of such concern; and where the concern is a company he must be the 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

(d) If the above conditions are satisfied then the payment by the company to the concern will be dividend.

12. The Special Bench of ITAT, Mumbai, in the case of *Bhaumik Color Labs ITA 5030/M/04, 118 ITD 1 (SB) (Mum)*, considered the question Whether deemed dividend u/s. 2(22)(e) of the Income Tax Act, 1961 can be assessed in the hands of a person other than a shareholder of the lender? The Special Bench held that deemed dividend can be assessed only in the hands of a person who is a shareholder of the lender company and not in the hands of a person other than a shareholder. The Special Bench on the above issue has observed as follows:-

"30. At the outset it has to be mentioned that provisions of Sec.2(22)(e) which brought in a new category of payment which was to be considered as dividend as introduced by the Finance Act 1987 w.e.f.1-4-88 viz., payment by a company "**to any concern in**

which such shareholder is a member or a partner and in which he has a substantial interest" do not say as to in whose hands the dividend has to be brought to tax, whether in the hands of the "concern" or the "shareholder". We have already seen the divergent views on this issue which have been referred to in the earlier part of this order.

31. The above provisions were subject matter of consideration before the Hon'ble Rajasthan High Court in the case of CIT Vs. Hotel Hilltop. 217 CTR 527(Raj). The facts of the case before the Hon'ble Court were as follows. The Assessee was one M/S.Hotel Hilltop a partnership firm. This firm received an advance of Rs.10 lacs from a company M/S.Hilltop palace Hotels (P) Ltd. The shareholding pattern of M/S.Hillltop Palace Hotels (P) Ltd., was as follows:

1. *Shri Roop Kumar Khurana : 23.33%*
2. *Smt.Saroj Khurana : 4.67%*
3. *Vikas Khurana : 22%*
4. *Deshbandhu Khurana : 25%*
5. *Shri.Rajiv Khurana : 25%*

The constitution of the firm Hotel Hill Top was as follows:

1. *Shri Roop Kumar Khurana: 45%*
2. *Shri.De hbandhu Khurana: 55%*

The AO asses ed the sum of Rs.10 lacs as deemed dividend u/s.2(22)(e) of the Act in the hands of the firm because the two partners of M/S.Hotel Hill Top were holding shares by which they had 10% voting power in M/S.Hill Top Palace Hotels (P) Ltd. They were also entitled to 20% of the income of the firm M/S.Hotel Hill Top. Therefore the loan by M/S.Hill Top Palace Hotels (P) Ltd. To the firm M/S.Hotel Hill Top was treated as deemed dividend in the hands of M/S.Hotel Hill Top, the firm under the Second limb of Sec.2(22)(e) of the Act. The CIT(A) held that since the firm was not the shareholder of the company the assessment as deemed dividend in the hands of the firm was not correct. The order of the CIT(A) was confirmed by the Tribunal.

On Revenue's appeal before the Hon'ble High Court, the following question of law was framed for consideration:-

> "Whether on the facts and in the circumstances of the case and in law the learned Tribunal was justified in upholding the order of learned CIT(A) deleting the addition of Rs.10 lacs as deemed dividend under Section 2(22)(e) of the IT Act? "

The Hon'ble Court held as follows:-

> " The important aspect, being the requirement of section 2(22)(e) is, that 'the payment may be made to any concern, in which such shareholder is a member, or the partner, and in which he has substantial interest or any payment by any such company, on behalf or for the individual benefit of any such shareholder ..... " Thus, the substance of the requirement is that the payment should be made on behalf of or for the individual benefit of any such shareholder, obviously, the provision is intended to attract the liability of tax on the person, on whose behalf, or for whose individual benefit, the amount is paid by the company, whether to the shareholder, or to the concerned firm. In which event, it would fall within the expression 'deemed dividend'. Obviously, income from dividend, is taxable as income from the other sources under section 56, and in the very nature of things the income has to be of the person earning the income. The assessee in the present case is not shown to be one of the persons, being shareholder. Of course, the two individuals being R and D. are the common persons, holding more than requisite amount of shareholding and are having requisite interest, in the firm, but then, thereby the deemed dividend would not be deemed dividend in the hands of the firm, rather it would obviously be deemed dividend in the hands of the individuals, on whose behalf, or on whose individual benefit, being such shareholder, the amount is paid by the company to the concern. Thus, the significant requirement of section 2(22)(e) is not shown to exist. The liability of tax, as deemed divided, could be attracted in the hands of the individuals, being the shareholders, and not in the hands of the firm."

32. The aforesaid decision of the Hon'ble Rajasthan High Court which is the only decision of High Court, should be sufficient to answer question No.2 which has been referred to the Special Bench by holding that deemed dividend can be assessed only in the hands of a person who is a shareholder of the lender company and not in the hands of a person other than a shareholder. The argument of the learned D.R. that the Hon'ble Rajasthan High Court did not deal with the second limb of Sec.2(22)(e) of the Act is not correct."

13. The Special Bench further held as follows:-

"34. We are of the view that the provisions of Sec.2(22)(e) does not spell out as to whether the income has to be taxed in the hands of the shareholder or the concern(non sha eholder). The provisions are ambiguous. It is therefore necessary to examine the intention behind enacting the provisions of Sec 2(22)(e) of the Act.

35. The intention behind enacting provisions of section 2(22)(e) are that closely held companies (i.e companies in which public are not substantially interested), which are controlled by a group of members, even though the company has accumulated profits would not distribute such profit as dividend because if so distributed the dividend income would became taxable in the hands of the shareholders. Instead of distributing accumulated profits as dividend, companies distribute them as loan or advances to shareholders or to concern in which such shareholders have substantial interest or make any payment on behalf of or for the individual benefit of such shareholder. In such an event, by the deeming provisions such payment by the company is treated as dividend. The intention behind the provisions of section 2(22)(e) is to tax dividend in the hands of shareholder. The deeming provisions as it applies to the case of loans or advances by a company to a concern in which it's shareholder has substantial interest, is based on the presumption that the loan or advances would ultimately be made available to the shareholders of the company giving the loan or advance. The intention of the legislature is therefore to tax dividend only in the hands of the shareholder and not in the hands of the concern.

36. The basis of bringing in the amendment to Sec.2(22)(e) of the Act by the Finance Act, 1987 w.e.f 1-4-88 is to ensure that persons who control the affairs of a company as well as that of a firm can have the payment made to a concern from the company and the person who can control the affairs of the concern can drawn the same from the concern instead of the company directly making payment to the shareholder as dividend. The source of power to control the affairs of the company and the concern is the basis on which these provisions have been made. It is therefore proper to construe those provisions as contemplating a charge to tax in the hands of the shareholder and not in the hands of a non-shareholder viz., concern. A loan or advance received by a concern is not in the nature of income. In other words there is a deemed accrual of income even u/s.5(1)(b) in the hands of the shareholder only and not in the hands of the payee viz., non-shareholder (Concern). Sec.5(1)(a) contemplates that the receipt or deemed receipt should be in the nature of income. Therefore the deeming fiction can be applied only in the hands of the shareholder and not the non-shareholder viz., the concern.

37. The definition of Dividend U/s.2(22)(e) of the Act is an inclusive defini ion. Such inclusive definition enlarges the meaning of the term “Dividend” according to its ordinary and natural meaning to include even a loan or advance. Any loan or advance cannot be dividend according to its ordinary and natural meaning. The ordinary and natural meaning of the term dividend would be a share in profits to an investor in the share capital of a limited company. To the extent the meaning of the word “Dividend” is extended to loans and advances to a shareholder or to a concern in which a shareholder is substantially interested deeming them as Dividend in the hands of a shareholder the ordinary and natural meaning of the word “Dividend” is altered. To this extent the definition of the term “Dividend can be said to operate. If the definition of “Dividend” is extended to a loan or advance to a non shareholder the ordinary and natural meaning of the word dividend is taken away. In the light of the intention

behind the provisions of Sec.2(22)(e) and in the absence of indication in Sec.2(22)(e) to extend the legal fiction to a case of loan or advance to a non-shareholder also, we are of the view that loan or advance to a non-shareholder cannot be taxed as Deemed Dividend in the hands of a non-shareholder."

14. The aforesaid view has since been approved in several decisions rendered by Hon'ble High Court of Bombay and Delhi in the case of *CIT Vs. Universal Medicare Pvt. Ltd., 324 ITR 263 (Bom)*, *CIT Vs. Ankitech Pvt.Ltd. & others 340 ITR 14 (Del.), National Travel Services (2012) 249 CTR (del) 540* and the Hon'ble Karnataka High Court in the case of *CIT Vs. Sarva Equity (P) Ltd., (2014) 111 DTR 207 (Karn.)* and the Hon'ble Supreme Court in the case of *CIT Vs. Madhur Housing and Development Co. 401 ITR 152(SC)*. Since the Assessee in the present case is not a shareholder in the lender company, we are of the view that the above decision is squarely applicable to the facts of the Assessee's case.

15. In view of the aforesaid decision, we are of the view that the action of the revenue authoritie in bring to tax a sum of Rs.4 Crores as deemed dividend u/s.2(22)(e of the Act cannot be sustained and the said addition is directed to be deleted. The relevant ground of appeal of the Assessee is allowed.

16. The next issue that arises for consideration is with regard to the disallowance u/s. 14A of the Act. As far as the disallowance is concerned, the same is only with regard to disallowance of 'other expenses' under Rule 8D(2)(iii) of the Income-tax Rules, 1962 [the Rules]. The argument advanced on this issue are general and vague. The computation has been done by the AO in accordance with the provisions of relevant Rule. No case has been made out by the assessee as to why the action of the

revenue authorities in this regard are not correct. Hence this issue is decided against the assessee.

17. The other grounds with regard to charging of interest u/s. 234B & 234C of the Act are consequential and the AO is directed to give consequential relief.

18. In the result, the appeal by the assessee is partly allowed.

Pronounced in the open court on this 16th day of November, 2018.

Sd/-	Sd/-
(INTURI RAMA RAO)	(N.V. VASUDEVAN)
Accountant Member	VICE PRESIDENT

Bangalore,
Dated, the 16th November, 2018.

/ Desai Smurthy /

Copy to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar,
ITAT, Bangalore.