
Karnataka High Court Ruling - Advance given by a closely held company to its sister concerns and substantial shareholder does not fall within ambit of deemed dividend

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Background

The Karnataka High Court ('High Court') in the case of M/s Bagmane Constructions Private Limited and others¹ ('the tax payer') has held that advances given by a closely held company to its sister concerns and a substantial shareholder as a consideration for the goods received or for purchase of a capital asset which indirectly would benefit the company advancing the loan does not fall in the ambit of 'advance' used in Section 2(22)(e) of the Income-tax Act, 1961 ('the Act').

Consequently, the transaction is out of the purview of deemed dividend.

Facts of the case

- The taxpayer, a closely held company, advanced money to its sister concerns namely Bagmane Builders Pvt Ltd, Chandra Developers Pvt Ltd, Bagmane Leasing and Finance Pvt Ltd, Bagmane Construction Pvt Ltd and Raja Bagmane, the shareholder having 99% percent of the equity share capital in the taxpayer.
- The amounts were advanced by the taxpayer to these sister concerns for different assessment years 2004-05 to 2007-08 while the advance to Raja Bagmane

¹ ITA NO 473/ 2013 clubbed with others

pertained to the assessment years 2002-03 to 2007-08.

- Proceedings were initiated under Sections 153A and 153C against Raja Bagmane and the sister concerns respectively and they were asked to explain why the aforesaid amounts received should not be treated as dividend and taxed accordingly given that the said amounts were shown under the caption of 'unsecured loans and advances'.
- The taxpayer contended:
 - a) The amounts were advanced for sourcing agricultural land given that in Karnataka, companies are not allowed to buy the agricultural land.
 - b) The funds were given to procure the land in the name of the directors and hold the same in the form of capital asset and then transfer back to the company after obtaining conversion order. The same had been done by Sri Raja Bagmane during the assessment year 1997-98.
 - c) Details of such purchases, amounts paid and survey number of the land which was to be procured were submitted along with judgement of various Courts, supporting its case.
- The Assessing Officer held that the loans and advances would be covered by the provisions of section 2(22)(e) of the Act and tax is leviable to the extent of accumulated profits of the taxpayer after bringing out the following facts:
 - a) The documents submitted did not indicate the existence of any agreement between the taxpayer and its sister concerns till 15 December 2008.
 - b) The said agreement was also not registered with the concerned Government Authority. The deed

was dated 13 November 2012 and the period of limitation for specific performance of the contract has expired. Therefore, these indicate that the agreement was submitted for camouflaging the transaction.

- The Commissioner of Income-tax (Appeals) upheld the order of the Assessing Officer. On further appeal, the Income Tax Appellate Tribunal held that the assessing authority was not justified in invoking the provisions of section 2(22)(e) of the Act on account of the following:
 - a) Accounting does not alter the nature and character of transaction and it cannot be the sole reason to treat the advances as unsecured loans and the provisions of section 2(22)(e) have to be applied;
 - b) The agreement cannot be rejected on the ground of belated production;
 - c) The fiction in section 2(22)(e) only refers to pure advances or loans;
 - d) Transfer of funds arising out of commercial expediency to meet the complex constraints may not be in the nature of advance or loans in all circumstances.

Issue before the High Court

- Whether any payment by a company by way of advance or loan to a shareholder or to any concern made under Section 2(22) (e) of the Income Tax Act, 1961, to the extent to which the company possessed the accumulated profits constitutes deemed dividend?

Taxpayer's contention

- Proceedings under section 153A and 153C are invalid given that satisfaction of the Assessing Authority was not recorded in writing.
- As per the provisions of Karnataka Land Reforms Act, a non-agriculturist including a

company cannot purchase or own agricultural land. Hence, they form sister companies/ concerns and advance money to Directors or individual shareholders which enable them to buy agricultural land and get it converted. Therefore, these amounts are given as trade advances.

- The word 'advance' or 'loan' referred to in Section 2(22)(e) has to be interpreted in the context in which the said provisions was brought on the statute and the object which was sought to be achieved.
- The literal interpretation of the said provision would lead to absurdity and injustice and therefore purposive construction has to be placed on the said provision.

Revenue's contention

- At the time of advancing the money, no agreements existed. The material on record clearly established that it is a document created to support the claim of the taxpayer. Further, the document is not registered.
- The word 'any payment' in Section 2(22)(e) includes even a trade advance or monies lent or advances by way of business expenditure or commercial expedience. The Legislature has provided an exception - advance or loan in the ordinary course of business where lending of money is substantial part of business of the Company.
- Given that the taxpayer is not in the business of money lending, the payment is deemed to be dividend and liable to tax.

High Court's ruling

- Relying on various judicial precedents, the High Court held that the purpose of insertion of sub-clause (e) of Section 2(22) of the Act was to bring within the tax net accumulated profits which are distributed by closely held companies to its shareholders in the form of loans to avoid payment of dividend distribution tax under Section 115-O of the Act

- Gratuitous loan or advance given by a company to the shareholders would come within the purview of section 2(22) but not the cases where the loans or advances are given in return to an advantage conferred upon the company by such shareholder or a related entity to whom the provisions apply.
- Though the Legislature has introduced 'advance' as well as 'loan' which are two different words, the meaning of each of those words have to be understood in the context in which they are used. Therefore, when the said two words are used in the aforesaid provision with the purpose of levying tax, if the intention of such advance or loan is to avoid payment of dividend distribution of tax under Section 115-O of the Act, such a payment by a company certainly constitutes a deemed dividend

Our comments

This ruling of the Karnataka High Court would come as a relief to taxpayers as it carves trade advances out of the purview of deemed dividend. This would aid in greater flexibility in the conduct of business especially in real estate sector.

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