

# ***Exempt capital gains excluded from 'accumulated profit' for deemed dividend; deemed dividend provisions cannot be applied to non-shareholder family members***

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## ***In brief***

In a recent judgement, the Kolkata Income Tax Appellate Tribunal (Tribunal) held that deemed dividend provisions could not be invoked on taxpayers' family members who were not shareholders in the lending company. Further, the Tribunal also held that exempt capital gains did not form part of 'accumulated profits' for reckoning deemed dividend.

## ***In detail***

### ***Facts of the case***

- The taxpayer<sup>1</sup> held 40% stake in a company.
- The company had advanced money to the taxpayer as well as to his immediate family members.
- As per the Income-tax Act (IT Act), any loans or advances by a closely held company to its shareholder (holding at least 10 per cent of voting power) or any payment by such company on behalf, or for the individual benefit of, such shareholder is deemed to be dividend in the shareholder's hands to the extent of the company's accumulated profits of the company.

Further, as per explanation to the deemed dividend provisions in the IT Act ("explanation"), accumulated profits shall not include capital gains arising before April 01, 1956.

- The company had accumulated profits in its books when the above advance was made. These accumulated profits included exempt long term capital gains, which were earned during the year in which the advance was made.
- If the capital gains were to be excluded from the accumulated profits, the accumulated profits would be negative.
- The Tax Officer treated the amount advanced to the taxpayer and his family members as deemed

dividend and sought to tax the same.

The first Appellate Authority held that the money advanced to the taxpayer should be taxed as dividend. However, the money advanced to the family members could not be taxed as dividend, as they were not shareholders of the company.

### ***Issue before the Appellate Tribunal***

- Whether advances made to the taxpayer's family members who were not shareholders in the company could be treated as deemed dividend and taxed accordingly?
- Was the exempt capital gain excludible from accumulated profits for purpose of dividend provisions of the Act?

<sup>1</sup> I.T.A. No. 1703 & 2015/Kol/2014

## Taxpayer's contentions

### Issue 1

- Dividend provisions could not be invoked as family members were not shareholders of the lending company.
- Relying on the SC judgement,<sup>2</sup> it was argued that the provisions created a deeming fiction for taxation of dividend and hence had to be construed strictly.

### Issue 2

As per the explanation, accumulated profits would include capital gains only if it is chargeable to tax under the provisions of the IT Act and not otherwise. Relying on various judicial precedents<sup>3</sup>, it was argued that exempt capital gains do not form part of the accumulated profits for the purpose of dividend provisions.

## Tax authorities' contention

### Issue 1

Monies advanced to the taxpayers' family members had to be treated as deemed dividend in the taxpayer's hands.

### Issue 2

Under the IT Act, accumulated profits excluded capital gains only

up to April 01, 1956 and not thereafter.

## Tribunal's Ruling

### Issue 1

- The money advanced to the family members was neither on behalf of the shareholder nor for his individual benefit (relying on the SC decision)<sup>2</sup>.
- In the SC decision<sup>4</sup>, an advance was given to the employee, who in turn gave it to the shareholder, and thus the advance was given for the benefit of the shareholder.

However, in the instant case, family members did not act as a conduit for subsequent transfer of money to the taxpayer, and accordingly, the SC ruling was distinguished.

- Deemed dividend provisions can be assessed only in the hands of the shareholders and not otherwise. In the present case, as the taxpayers' family members were not shareholders in the lending company, deemed dividend provisions of the IT Act could not be invoked against them.

### Issue 2

- Relying on various judicial precedents<sup>3</sup>, it held that accumulated profits would not include capital gains,

whether made before April 01, 1956 or after that date).

- Profits earned during the current year were also added to the accumulated profits for calculation of deemed dividend. It was nowhere contemplated that 'accumulated profits' would include any capital profits which were not liable to capital gains tax. Thus, capital gains could be included for calculating accumulated profits only when the capital gains have been subjected to tax.
- Consequently, any payment made to a shareholder of a company from exempt capital gains of the company would not be considered as deemed dividend.

## Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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<sup>2</sup> CIT v. C. P. Sarathy Mudaliar [1972] 83 ITR 170 (SC)

<sup>3</sup> CIT v. Mangesh J. Sanzgiri [1979] 119 ITR 962 (Bom) and ACIT v. Gautam Sarabhai Trust No. 23 [2002] 81 ITD 677 (Ahd Tribunal)

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<sup>4</sup> L Alagusundaram Chettiar v. CIT(2001) 252 ITR 893 (SC)

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