

INTER CORPORATE DEPOSIT (ICD) WHETHER DIVIDEND U/S 22(e) - A CASE STUDY

Facts assumed for case study

X Ltd has taken a working capital loan from State Bank of India worth Rs.10 crores. The same was given as Inter Corporate Deposit (referred as “ICD” for short hereinafter) to the flagship company Y Ltd. It is assumed that the accumulated profits of ‘X Ltd’ are more than Rs.10 crores. Both the companies have common directors and common shareholders. The name of the common directors and the pattern of the majority shareholding are as follows:

SL No.	Name of the shareholder	X Ltd % of Holdine	Y Ltd % of Holdine
1	A	50	20
2	B	50	20
3	C	0	60
	TOTAL	100	100

The contention of the Income Tax department is that such ICD should be treated as deemed dividend under section 2(22)(e). This case study examines whether the said contention is correct.

Dividend Under section 2(22)(e)

The term “dividend” in its ordinary meaning is a distributive share of the profits or income of a company given to its shareholders. In the Income Tax Act, 1961 (referred as “Act” for short hereinafter) “dividend” is inclusively defined. The definition comprises of 5 clauses. Clause ‘e’ is relevant for the present discussion.

As per clause (e) to section 2(22) “dividend” includes:

..

..

(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 31st day of May, 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) outlines the meaning of term “concern” and “substantial interest” for the purpose of section 2(22). The explanation reads: *For the purposes 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 per cent of the income of such concern ;

As per clause (a) to Explanation 3 to section 2(22), the term “concern” includes partnership firm, HUF, AOP, BOI and Company. Clause (b) to Explanation 3 to section 2(22) provides that a person shall be deemed to have substantial interest in a concern, if he is beneficially entitled to 20% or more of the income of such concern. Along with partnership firm, HUF, AOP and BOI clause (a) also includes ‘company’ for the purpose of meaning of a “concern”. However clause (b) while defining the term “substantial interest” in relation to a “concern” excludes company from the meaning of “concern”. This is because section 2(32) covers such a contingency.

Section 2(32) of the Act defines the term “person who has substantial interest in the company”. The section reads “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 per cent of the voting power”.

Clause (e) to section 2(22) is applicable to payments by a “closely held company”. As per section 2(22)(e) any payment by way of advance or loan to a concern, shall be considered as dividend to the extent, the company possesses accumulated profits. The advance or loan shall be considered as dividend, provided the shareholding threshold in both the companies (i.e. the granting and receiving companies) is satisfied. In the instant case from the table as furnished, this test is satisfied.

The transactions covered under section 2(22)(e) are payments made by way of advance or loan to a company. The section does not cover payments made by way of deposits to a company. The terms “advance”, “loan” and “deposit” have different connotations.

Advance: The Black Law’s dictionary defines the term “advance payment” as “a payment made in anticipation of a contingent or fixed future liability or obligation”. Ordinarily an “advance” is a payment beforehand and it does not connote the idea of repayment. An advance payment, or simply an advance, is the part of a contractually due sum that is paid in advance for goods or services. The balance included in the invoice will follow the delivery. It is called a prepaid expense in accrual accounting. In certain cases it may be a loan but it cannot be said that a sum paid by way of advance is necessarily a loan. It is adjusted when the action for which the money is advanced is completed and if not, repaid like a deposit.

Loan: The Black Law’s dictionary defines the term “loan” as “an act of lending, a grant of something for temporary

Test everything, try everything, and then believe it, and if you find it for the good of many, give it to all.

use, a sum of money lent at interest". A loan is a type of a debt. In a loan, the borrower initially receives or borrows an amount of money, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. The loan is generally provided at a cost, referred to as interest on the debt, which provides an incentive for the lender to engage in the loan.

Deposit: The Black Law's dictionary defines the term "deposit" as *"the Act of giving money or other property to another who promises to preserve it or to use it and return it in kind"*. The depositor goes to the depositee for investing his money primarily with the intention of earning interest. The obligation to repay the deposit depends upon the maturity date fixed or the terms of the agreement relating to the demand.

The distinction between a loan and a deposit is that, a deposit does not impose an immediate obligation on the depositee to seek out the depositor and repay him. He is to keep the money till asked for it. A demand by the depositor would, therefore, seem to be a normal condition of the obligation on the depositee to repay. It is only upon the expiration of the term that a deposit falls repayable by the depositee. However, in the case of loan, the obligation to repay the loan does not depend on demand but comes into existence as soon as the loan is given. The loan is recoverable the minute it is advanced while the deposit is not.

In the case of AN Shamsudeen v. Union of India and others (2000) 244 ITR 266 the Madras High Court had an occasion to distinguish loan from deposit. It held as follows:

"..... The mere presence of some of the attributes of the loan transaction in a deposit would not be sufficient to regard a loan as a deposit. They are two different transactions in the commercial word.

The distinction between a loan and a deposit is that in the case of the former it is ordinarily the duty of the debtor to seek out the creditor and to repay the money according to the agreement and in the case of the latter it is generally the duty of the depositor to go to the Banker or to the depositee, as the case may be, and make a demand for it."

The Bombay High Court in the case of **Durga Prasad Mandelia v. Registrar of Companies [1987] 61 Comp. Cas. 479 (Bom)**, distinguished deposits and loans in the context of section 370 of the Companies Act. The Court held as under:

"There can be no controversy that in a transaction of a deposit of money or a loan, a relationship of a debtor and creditor must come into existence. The terms "deposit" and "loan" may not be mutually exclusive, but nonetheless in each case what must be considered is the intention of the parties and the circumstances. In the present case, barring the assertion of the respondent that the moneys advanced by the company to the Associated Cement Companies Ltd. constitute a loan under section 370 of the Companies Act, there is nothing else to show that these moneys have been advanced as a "loan". In the context of the statutory provisions, the word "loan" may be used in the sense of a "loan" not amounting to a deposit. The word "loan" in section 370 must now be construed as dealing with loans not amounting to deposits, because, otherwise, if deposit of moneys with corporate bodies were to be treated as loans, then deposits with scheduled banks would also fall within the ambit of section 370 of the Companies Act. Therefore, moneys given by the company to the other bodies corporate is a loan within the meaning of section 370 of the Companies Act must be negated. Therefore, the petitioners would well be entitled to the relief."

Section 370 of the Companies Act, 1956 was subsequently amended to include 'deposits' into its ambit thereby

indicating the distinction between 'deposits' and loans/advances.

The Ahmedabad Tribunal in **Gujarat Gas Financial Service Ltd v. Asstt. CIT [2008] 115 ITD 218** (Ahd.) in the context of the Interest Tax Act held that interest on inter-corporate deposits is not akin to interest on loans or advances. The Tribunal held *"it is trite law that no tax can be imposed on the subject without the words in the Act. No tax can be imposed by inference or analogy. The cardinal principle of interpretation of fiscal law is that it should be considered strictly. In view of the above, the interest in inter-corporate deposits unless they clearly fall within the meaning of interest on loans and advances' would not be taxable. Inter-corporate deposit can neither be a loan nor an advance."*

In the instant case, the transaction of deposit given by X Ltd to Y Ltd is an Inter Corporate Deposit. An Inter-Corporate Deposit (ICD) represents funds extended by one corporate to another. ICDs are unsecured, and hence the inherent risk is high. These monies would be given without collateral. Hence a higher rate of interest would be demanded by the lender. The short term credit rating would determine the rate at which the corporate would be able to secure an inter corporate deposit. The tenor of ICD may range from 1 day to 1 year, but the most common tenor of borrowing is for 90 days.

The ICD's if at all can be considered as dividend, will have to be considered under the fifth clause of section 2(22) i.e. section 2(22)(e). A question that arises in the case of ICD's is whether these deposits can be considered as dividends?

Clause 22 of section 2 brings into the tax net certain types of receipts which are treated as dividends, though

they may not otherwise fall within the meaning of that expression as used in company law. By Finance Act 1955 sub-clause (e) to clause 22 was inserted. This sub-clause treats loans granted by a 'closely held' company to any shareholders in the same manner as it treats dividends distributed by it to them.

Before this provision was inserted, the company in question could arrange the distribution of accumulated profits by way of loan to a shareholder who had substantial interest in the company. In such an arrangement, the shareholder escaped liability to pay tax. To curb the above malpractice, sub-clause (e) was inserted under clause 22. The provisions of this sub-clause have undergone two important changes as a result of amendment by Finance Act, 1987. The section was widened to include advances and loans made to a shareholder, who is the beneficial owner of shares holding 10% or more of the voting power of the company. Secondly, the advances or loans made to any concern in which such shareholder is a member or partner having substantial interest were brought within the ambit of the definition. Transactions covered by clause 'e' are in a general understanding deemed to be dividends. It is interesting to note that the word "deemed" is not used in section 2(22)(e). Deemed dividend is therefore a legal fiction. Being a legal fiction it has to be understood and interpreted within the framework of the purpose for which it is created. The fiction cannot extend beyond its legitimate field. The section is to be strictly constructed. The purpose of clause 'e' was to rope in transactions that were intrinsically for the benefit of the shareholder and hence dividend

but apparently described as loan or advance. The purpose was not to tax monies passing under legitimate business transactions.

In the following cases it has been held that the payment for genuine and legitimate business transactions would be outside the scope of section 2(22)(e) of the Income-tax Act, 1961:

- 1) *Commissioner of Income Tax v Nagindas M. Kapadia* (1989) 177 ITR 0393 (BOM)
- 2) *NH Securities Ltd. v. Deputy Commissioner of Income-tax, Cent. Cir. 40*, (2007) 11 SOT 302 (Mumbai)
- 3) *Asstt. CIT v. Global Agencies (P.) Ltd.* (2004) 1 SOT 510

In the case of **Bombay Oil Industries Ltd. vs DCIT 28 SOT 383** the Bombay Tribunal has held that *"Section 2(22)(e) enacts a deeming fiction whereby the scope and ambit of the word dividend has been enlarged to bring within its sweep certain payments made by a company as per the situations enumerated in the section. Such a deeming fiction would not be given a wider meaning than what it purports to do. The provisions would necessarily be accorded strict interpretation and the ambit of the fiction would not be pressed beyond its true limits. The requisite condition for invoking section 2(22)(e) of the Act is that payment must be by way of loan or advances. Since there is a clear distinction between the inter-corporate deposits vis-a-vis loans/advances, according to us the authorities below were not right in treating the same as deemed dividend under section 2(22)(e) of the Act. Since we hold that ICDs do not come within the purview of deemed dividend under section 2(22)(e) of the Act."*

Based on the above it could be said that an inter-corporate deposits will not come within the purview of deemed dividend under section 2(22)(e) of the Act. ■