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India | Tax & Regulatory | 14 December 2015

# Global Business Tax Alert
## Sharp Insights

## Capital gains exempt from tax to be excluded for the purpose of computing ‘accumulated profit’

**Issue no: GBTA/84/2015**

**In this issue:**

The Kolkata Tribunal in the case of Sri Manoj Murarka ("assessee") has held that the provisions of deemed dividend cannot be invoked on assessee's family members who are not shareholders in the lending company. The Tribunal also held that exempt capital gains income is not to be included for the purpose of computing accumulated profits for the purpose of determining deemed dividend in the hands of the assessee.

The assessee was an individual holding substantial shareholding of 41.84% in M/s Bathilivala and Karani Financial Consultants Pvt. Ltd ('BKFCPL'). During Financial Year 2006-07, BKFCPL advanced money aggregating to Rs.1.86 crores to the assessee and his family members (being his wife, son and daughter). BKFCPL was not engaged in the business of money lending but was actually engaged in the business of dealing shares, securities and other investments.

The Assessing Officer ('AO') completed the original assessment. However, the order of the AO was sought to be revised by the Commissioner of Income-tax ('CIT') in order to examine the aspect of deemed dividend in respect of amounts overdrawn by the assessee from BKFCPL.

The CIT sought to tax only the amount withdrawn by the assessee. However, the AO, while giving effect to the order of the CIT made additions on account of the amount overdrawn by the assessee's son and daughter as deemed dividend in the hands of the assessee. On appeal, the Commissioner of Income-tax (Appeals) ['CIT(A)'] decided this issue in favour of the assessee.

The CIT(A), however, confirmed the addition made towards deemed dividend in respect of the amount overdrawn by the assessee thereby ignoring the contentions of the assessee that there was only negative accumulated profits if the long term capital gains which is exempt from tax is excluded from accumulated profits.

**Deemed dividend cannot be invoked on assessee's family members who are not shareholders in the lending company**

In respect of the issue of taxing of amounts withdrawn by the son and daughter of the assessee by the AO as deemed dividend in the hands of the assessee, the Tribunal held that the AO had travelled beyond jurisdiction vested in him by the order of the CIT.

The Tribunal further distinguished the decision of the Supreme Court in the case of L.Alagsundaram Chettiar vs. CIT (252 ITR 893) relied upon by the Tax Authorities on facts and held that in the instant case, the money was advanced directly by the company to the son and daughter of the assessee and unlike the case in the decision of the Supreme Court, it was not the case of the revenue that the money was subsequently transferred by son and daughter to the assessee and the children merely acted as a conduit to draw money from the company for onward transmission to the assessee

The Tribunal placed reliance on the decision of the Supreme Court in the case of C.P. Sarathy Mudlaiar (83 ITR 170) and observed that both the son and daughter of the assessee were not shareholders in BKFCPL and hence, the deemed dividend, if any, could be assessed only in the hands of the shareholders and not otherwise.

**Exempt capital gains to be excluded for the purpose of computing accumulated profits**

In respect of the addition made towards deemed dividend in respect of the amount overdrawn by the assessee, it was submitted by the assessee before the Tribunal that the accumulated profits as at the end of the relevant financial year admittedly included exempted long term capital gains and if the same are reduced, then there will be only negative accumulated profits and the provisions of deemed dividend could not be invoked. The assessee further contended that the expression 'accumulated profits' would include capital gains only if it is chargeable to tax as per the provisions of the Income-tax Act ('the Act').

The Tribunal held that for the purpose of definition of deemed dividend as contained in the Act, the accumulated profits do not include any capital gains, except those which are taxable as such. Accordingly, accumulated profits would not include capital gains made during a period when they were not taxable under the Act, nor capital gains which are not chargeable even during the period the capital gain tax is in force. As a result, any payment made to a shareholder of a company of non-taxable capital gains of the company would not be dividend. In holding this, the Tribunal placed reliance on the following decisions:

- Bombay High Court in the case of Mangesh J Sanzgiri (119 ITR 962),
- Kerala High Court in the case of Smt. Chechamma Thomas (161 ITR 718) and;
- Ahmedabad Tribunal in the case of Gautam Sarabhai Trust No.23 (81 ITD 677)

The Tribunal further explained that for reckoning the accumulated profits, apart from the opening balance of accumulated profits, profits earned during the current year also are to be added and then these accumulated profits should be considered for the purpose of calculation of deemed dividend. The Tribunal further held that it was nowhere contemplated under the Act that 'accumulated profits' will include any capital profits which were not liable to capital gains tax.

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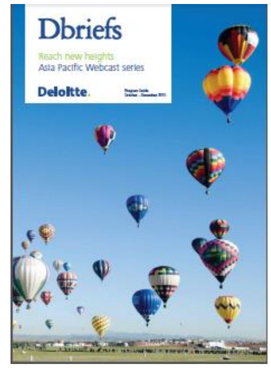


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