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COMMISSIONER OF INCOME TAX, KOLKATA

v

MUKUNDRAY K. SHAH

APRIL 10, 2007

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[S.H. KAPADIA AND B. SUDERSHAN REDDY, JJ.]

*Income Tax Act, 1961*

*Section 2(22)(e)—Deemed dividend—*

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*Diary belonging to assessee, seized by department during search of premises of a company, MKSEPL, indicating investment by him in bonds—Assessing Officer finding that bonds were purchased from money received from two firms in which assessee was partner, and their books of account showed repayment of loans and advances from three companies, including MKSEPL, which were closely related private limited companies, wherein assessee had controlling interest and considerable voting power—Assessing Officer concluding that MKSEPL had accumulated profits but deliberately refused to distribute them as dividends to its shareholders, and money paid by it to two firms was for purchase of bonds by assessee which was assessable as deemed dividend in his hands under Section 2(22)(e)—Correctness of—Held—Entries discovered during search had direct co-relation with payment by MKSEPL to two firms and payments by said two firms to assessee who used it to buy bonds; said funds were not repayment of loans—Timing of so-called repayments by company to those firms and immediate withdrawal of funds by assessee and timing of purchase of bonds was around same time—It was noteworthy that in MKSEPL assessee was not only a shareholder having more than 10% of total voting power, but was also its Director, and said company was partner in the two firms; also withdrawal of money by assessee were debited in capital account of firm leading to a debit balance.*

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*Merger of companies—Effect of—Held—Reserves had to be taken on basis of merged account.*

*Chapter XIV-B dealing with block assessment—Invocation of—Undisclosed income in nature of deemed dividend detected wholly and exclusively as a result of a search by department and not from any scrutiny*

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*proceedings, tax evasion petitions, surveys, information received from external agency etc.—Case of circular trading wherein funds were routed through conduits and clear picture emerged only after seeing cash flow statements—Held—Department was right in invoking provisions of Chapter XIV-B.* A

*Section 260A—Appeal to High Court—Interference with finding of facts of Tribunal—Held—Question as to whether payment by company is for benefit of assessee is a question of fact—Conclusions of Tribunal that it was routed through other firms for benefit of assessee, on date of payment there existed accumulated profits and all withdrawals were debited in capital account of firm leading to debit balance, were findings of facts—These were not perverse and could not be interfered by High Court—Section 2(22)(e).* B C

*Words and phrases—Circular trading—In the context of Chapter XIV-B of Income Tax Act, 1961.*

Appellant, the Income Tax Department, searched the premises of a company, MKSEPL and seized a diary titled "ML-20" belonging to respondent-  
 assessee. The diary indicated investment of Rs.26.35 crores by the respondent  
 in 9% RBI Relief Bonds between 17.11.99 and 11.2.2000 during the  
 accounting year ending 31.3.2000. The Assessing Officer found that the said  
 Bonds were purchased from the money received from two firms, MKF and  
 MKI, in which the respondent was partner. In the books of account, the said  
 two firms were shown to have received back the loans and advances from three  
 companies viz. MKTPL, SCPL and MKSEPL, which were closely related  
 private limited companies, wherein the respondent had controlling interest  
 and considerable voting power. On the basis of the said diary and the cash  
 flow chart, the Assessing Officer concluded that (i) MKSEPL had accumulated  
 profits but deliberately refused to distribute them as dividends to its  
 Shareholders; (ii) Rs.5.99 crores was paid by MKSEPL (including SCPL) in  
 the Accounting Year 1999-2000 to MKF and MKI respectively for the  
 purchase of 9% RBI Relief Bonds by the respondent, and assessed the said  
 sum as deemed dividend in the hands of the respondent under Section 2(22)(e)  
 of the Income Tax Act, 1961. It was more so as SCPL stood merged with  
 MKSEPL with effect from 18.5.98 G

Aggrieved by the Assessment Order, the respondent filed an appeal  
 before Commissioner of Income Tax (Appeals), which was allowed. Against  
 this appellant appealed to the Tribunal. The Tribunal held that (i) Section  
 2(22)(e) was attracted to facts of the case since disbursement was made by  
 MKSEPL; (ii) all payments should be taken to have originated from MKSEPL H

**A** (iii) in January/February 2000 when payments were made by MKI and MKF to the respondent, SCPL had no independent existence in law having merged with MKSEPL with effect from 18.5.98; therefore shareholding of respondent in SCPL and its accumulated profits were liable to be taken into account; (iv) though the respondent had bought the Bonds for Rs.26.35 crores, restriction of deemed dividend amount to Rs.5.99 crores was correct since known company sources had to be eliminated. Accordingly, the Tribunal allowed the appeal.

**B**

**C** Aggrieved by the decision of the Tribunal, the respondent appealed to the High Court. The High Court held that (i) as the respondent had declared the primary facts in the returns, it was not a case of undisclosed income, but of regular assessment which did not fall under Chapter XIV-B of the Act; (ii) none of the Authorities below had held that the entries in the books of accounts were fictitious; (iii) all payments were made by cheque; (iv) moneys were lent and advanced by MKSEPL to MKF and MKI in normal course of business; (v) the Tribunal erred in holding that MKF and MKI were conduits for routing the money from MKSEPL to the respondent as there was no evidence in that regard; (vi) there was no evidence to show that payments were made by MKSEPL for the individual benefit of the respondent; (vii) when Rs.26.35 crores was invested in the above financial year, there was no reason to treat Rs.5.99 crores as deemed dividend. For the above reasons the High Court set aside the judgment of the Tribunal. Hence present appeal.

**D**

**E** Appellant contended that under Section 260A of the Act the High Court should not have interfered with the findings of facts recorded by the Tribunal as there was neither a substantial question of law nor any perversity in its findings.

**F** Respondent contended that the appellant was wrong in treating the accumulated profits of MKSEPL as accumulated profits of SCPL merely because the merger became effective retrospectively with effect from 18.5.98. It was more so as MKSEPL had not merged with SCPL but SCPL had merged with MKSEPL.

**G** Allowing the appeal, the Court

**H** HELD 1.1. The Tribunal was right in holding, on examination of the cash flow statement, that MKSEPL had made payments to MKF and MKI for the benefit of the assessee which enabled the assessee to buy 9% RBI Relief Bonds in the F.Y. 1999-2000. It is in this sense that the Tribunal was right in

holding that the two firms were used as conduits by the assessee. It is not in dispute that the assessee had more than 10% of voting power in MKSEPL during the block period. It is not in dispute that the assessee had substantial interest of about 16% in MKF. It is not in dispute that the three companies were the controlled companies. [Para 12] [1118-A-C] A

*Commissioner of Income-Tax, Madras-I v. L. Alagusundaram Chettiar*, (1977) 109 ITR 508, approved. B

1.2. The timing of so-called repayments by the company to MKF and MKI and the immediate withdrawal of the funds by the assessee-cum-Director-cum-shareholder-cum-partner and the timing of investment in purchase of Bonds were around the same time. Moreover, in MKSEPL the assessee is not only a shareholder having more than 10% of total voting power, he is also a Director of that company. The said company is also a partner in MKF and MKI which explains why the amount of Rs.5.99 crores was routed by splitting the said amount into two parts of Rs.2.79 crores and Rs.3.20 crores. C

[Para 12] [1118-C-D] D

1.3. The most important aspect, which has not been considered by the High Court, was that withdrawal of money by the assessee from his capital account, in the books of MKI, during F.Y. 1999-2000 led to a debit balance of Rs.8.18 crores as on 31.3.2000. To this extent, the finding given by the A.O. and by the Tribunal remains unchallenged. [Para 12] [1118-D-E] E

2.1. On the maintainability of the block assessment, the Department was right in assessing the said amount as deemed dividend in the hands of the assessee under Section 2(22)(e) of the Act. The impugned Assessment Order was passed under Section 158BC. That assessment originated on account of a search conducted under Section 132(1) of the Act. In that search the diary "ML-20" was identified. That identification was the starting point of connected enquiries resulting in the detection of undisclosed income of Rs.5.99 crores. In other words, undisclosed income, in the nature of deemed dividend, did not arise from any scrutiny proceedings, tax evasion petitions, surveys, information received from external agency etc. The undisclosed income was detected by the A.O. wholly and exclusively as a result of a search and, therefore, the Department was right in invoking the provisions of Chapter XIV-B. [Para 12] [1118-E-G] F G

2.2. The Department has established a sort of circular trading in this case. One of the important features of circular trading is to route the funds H

**A** through conduits. In such cases the picture emerges only after seeing the cash flow statements. In the present case, ML-20 made the A.O. to hold enquiries and in that enquiry the cash flow statement emerged, therefore, the Department was right in invoking the provisions of Chapter XIV-B in the present case. The five payments had direct co-relation with Rs.5.99 crores paid by MKSEPL to MKF and MKI and payments by the said two firms to the assessee who used the said money to buy 9% RBI Relief Bonds. Therefore, the said payment by the company through the two firms was for the benefit of the assessee. Therefore, the said funds were not repayment of loans, they were for purchase of 9% RBI Relief Bonds by the respondent. [Para 12]

[1118-G-H; 1119-A-B]

**C** 3. The A.O. was correct in expressing the view that on merger the accounts of the two companies had merged and, therefore, the reserves had to be taken on the basis of merged account. Moreover, the assessee had substantial interest in MKSEPL right from the inception. [Para 13] [1119-C]

**D** 4.1. The question as to whether payment made by the company is for the benefit of the assessee is a question of fact. In this case, the Tribunal has concluded that the payment routed through MKF and MKI was for the benefit of the assessee. This was a finding of fact. It was not perverse. Therefore, the High Court should not have interfered with the said finding.

[Para 16] [1121-D]

**E** *Nandlal Kanoria v. Commissioner of Income-Tax, Central, Calcutta, (1980) 122 ITR 405 and Commissioner of Income-Tax (Central), Bombay v. P.K. Badiani, (1970) 76 ITR 361, approved.*

**F** 4.2. The concept of deemed dividend under Section 2(22)(e) of the Act postulates two factors, namely, whether payment is a loan and whether on the date of payment there existed "accumulated profits". These two factors have to be correlated. This correlation has been done by the Tribunal coupled with the fact that all withdrawals were debited in the capital account of the firm leading to the debit balance of Rs.8.18 crores. The High Court has erred in disturbing the findings of fact. [Para 16] [1121-E]

**G** 5. The companies having accumulated profits and the companies in which substantial voting power lies in the hands of the person other than the public (controlled companies) are required to distribute accumulated profits as dividends to the shareholders. In such companies, the controlling group can do what it likes with the management of the company, its affairs and its

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profits. It is for this group to decide whether the profits should be distributed as dividends or not. The declaration of dividend is entirely within the discretion of this group. Therefore, the legislature realized that though funds were available with the company in the form of profits, the controlling group refused to distribute accumulated profits as dividends to the shareholders but adopted the device of advancing the said profits by way of loan to one of its shareholders so as to avoid payment of tax on accumulated profits. This was the main reason for enacting Section 2(22)(e) of the Act. [Para 11] [1117-D-F]

CIVIL APPELLATE JURISDICTION : Civil Appeal No. 1873 of 2007.

From the Judgment and Order dated 12.05.2005 of the High Court of Calcutta in G.A. No. 321 of 2005 and ITA No. 21 of 2005.

Mohan Parasaran, A.S.G., Chidananda, Gaurav Dhingra, K.K. Senthilvelan and B.V. Balaram Das for the Appellant.

N.K. Poddar and Rakha Rangaswamy for the Respondent.

The Judgment of the Court was delivered by

**KAPADIA, J.** 1. Leave granted.

2. A short question which arises for determination in this civil appeal filed by the Department: whether payments made by M. K. Shah Exports Pvt. Ltd. (for short, 'MKSEPL') during the Accounting Year ending 31.3.2000 (Assessment Year 2000-01) amounting to Rs.5.99 crores was made to the two firms M/s. M.K. Foundation (for short, 'MKF') and M/s. M.K. Industries (for short, 'MKI') for the benefit of respondent-assessee herein, Mukundrai K. Shah.

3. Department sought to tax the said amount of Rs.5.99 crores as undisclosed income in the hands of the assessee. On 24.8.2000, the Department searched the premises of the assessee under Section 132 of Income Tax Act, 1961 (for short, 'the Act'). During the search apart from cash and jewellery a diary titled "ML-20" was seized. On 16.11.2000, during the search the statement of Kalpesh Shah, son of the assessee, was also recorded under Section 132(4) of the said Act. Statement of the assessee was also recorded on that date. The diary indicated investment of Rs.26.35 crores by the assessee in 9% RBI Relief Bonds during the accounting year ending 31.3.2000. By the Assessment Order dated 29.11.2002, the said amount of Rs.5.99 crores was assessed as a deemed dividend under Section 2(22)(e) of the said Act. The A.O. took into consideration the income of the assessee for the block period, under Chapter

- A XIV-B at Rs.65.77 crores. This was for the block period 1.4.90 to 24.8.2000 (for short, "block period"). The diary was seized from the premises of MKSEPL. It belonged to the assessee. The assessee was asked to explain the sources of investment of Rs.26.35 crores in purchase of 9% RBI Relief Bonds during Financial Year 1999-2000. The said Bonds were purchased between 17.11.99 and 11.2.2000. The A.O. found that the said Bonds were purchased from the money received from MKF and MKI (for short, 'two firms') in which the assessee was the partner. In the books of account the said two firms were shown to have received back the loans and advances from three companies M.K. Tea (P) Ltd. (for short, 'MKTPL'), Safari Capital (P) Ltd. (for short, 'SCPL') and MKSEPL, which three companies were closely related companies,
- B in which the assessee had controlling interest. All three companies were private limited companies in which the assessee had considerable voting power. However on the basis of the said diary and the cash flow chart, the A.O. concluded that Rs.5.99 crores was paid by MKSEPL (including SCPL) and Rs.94 lakhs by MKTPL in the Accounting Year 1999-2000 to MKF and MKI respectively for the purchase of 9% RBI Relief Bonds by the assessee.
- C In the circumstances, by the Assessment Order, the Department assessed the said sum as deemed dividend in the hands of the assessee under Section 2(22)(e) of the Act. It was held that MKSEPL, SCPL and MKTPL (for short, 'three companies') were the companies in which the public was not substantially interested; that the assessee was one of the shareholders having more than
- D 10% total voting rights of MKSEPL and SCPL; that in MKTPL the total shareholding of the assessee was 9.3% and, therefore, he was not the beneficial owner of the shares of the said companies. It was further held by the A.O. that SCPL stood merged with MKSEPL with effect from 18.5.98. This was by the Order of the Calcutta High Court dated 5.7.2001. Therefore, according to the Order of Assessment, the alleged repayments by MKSEPL including
- E SCPL were not repayments but they were payments made by MKSEPL (including SCPL) to MKF and MKI for the individual benefit of the assessee amounting to Rs.5.99 crores which was held to be a deemed dividend under Section 2(22)(e) of the Act. Before the A.O. the assessee contended that during the financial year 1999-2000, his shareholding in MKTPL was only
- F 9.3% and, therefore, he was not having substantial interest in the said company; that similarly he was not having substantial interest in SCPL in which his shareholding in the F.Y 1999-2000 was only 0.2%; that the assessee was one of the partners in MKF and MKI and that the said two firms did not have substantial interest in MKSEPL, SCPL and MKTPL; that reserves and surplus of MKSEPL cannot be taken as reserves and surplus of SCPL which was
- G merged with the company with effect from 18.5.98; that MKI had advanced
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loan to SCPL which was repaid; that payment made by MKSEPL to MKF was through the current account and that the withdrawal made by the assessee from the two firms were debited to his capital account in the books of MKF and MKI and, therefore, the assessee contended that the said payments were not made to the said two firms for his individual benefit. These arguments were rejected by the A.O. It was held that the assessee had substantial interest in MKSEPL in which SCPL stood merged with effect from 18.5.98; that there was no merit in the contention of the assessee that the two firms, in which he was the partner, were not beneficial owner of shares of MKSEPL and SCPL; that the only relevant criteria was whether payments made to the said two firms was for the individual benefit of the assessee, who was the shareholder in MKSEPL. This point, according to the A.O., became relevant since the only issue which arose for determination in this case was the issue of deemed dividend under Section 2(22)(e) of the Act. According to the A.O., the said two firms-MKI and MKF, were the conduits enabling the assessee to take out the money from the company by using the said two firms as conduits. According to the A.O., payment of Rs.5.99 crores was not made directly to the assessee by MKSEPL but through the above-mentioned two firms-MKF and MKI. At this stage, it needs to be mentioned that there is no dispute that 9% RBI Relief Bonds were purchased by the assessee out of the funds available with MKI and MKF who in turn were funded by MKSEPL including SCPL. It is also not in dispute that the assessee had the majority of the voting power in MKSEPL. It is not in dispute that the said company, MKSEPL, had accumulated profits but according to the A.O. the said company deliberately refused to distribute the said accumulated profits as dividends to its shareholders and instead adopted the device of advancing the said accumulated profits as loan to the assessee who was the shareholder of the said company. According to the A.O., it was a device to evade payment of tax on accumulated profits.

4. Aggrieved by the Assessment Order dated 29.11.2002, the assessee went in appeal to Commissioner of Income Tax (Appeals) (for short, 'CIT (A)') under Section 158BC(c) read with Section 143(3) of the Act. By the Order dated 21.2.03, it was held by CIT (A) that the assessee did not possess any substantial interest in MKTPL or in SCPL during F.Y 1999-2000; that MKF and MKI had no substantial interest in MKSEPL, SCPL and MKTPL during F.Y. 1999-2000; that SCPL did not make any loan to MKI during the financial year 1999-2000; that SCPL had borrowed money from MKI and all payments made by SCPL during F.Y. 1999-2000 were repayments of loans advanced by MKI; that the assessee had 16% share in MKF; that MKSEPL had a current

A account in the books of MKF and that in most cases MKF had advanced loans to MKSEPL. According to CIT(A), MKSEPL have repaid those loans to MKF in which the assessee had substantial interest. According to CIT(A), the nature of transactions between MKF and MKSEPL consisted of a running account; it consisted of giving of loans and repayments thereof. According to CIT(A), none of the two firms had any substantial interest in MKSEPL, SCPL and MKTPL. According to CIT(A), all withdrawals made by the assessee from MKF and MKI including the impugned sum were debited to the assessee's capital account in the books of MKF and MKI. According to CIT(A), MKSEPL and SCPL had a regular account in MKF and MKI even before the purchase of the said Bonds and that the said two firms had advanced loans to MKSEPL and SCPL even in the earlier years as well as in the financial year 1999-2000 and, therefore, there was no motive in the debtor companies repaying their debts to MKF and MKI. According to CIT(A), merely because repayments were made by MKSEPL and SCPL through MKF and MKI in January/February 2000 and merely because the said amounts were partly utilized by the said two firms in making payments to the assessee who bought 9% RBI Relief Bonds therefrom, did not necessarily mean that the assessee had routed the funds of MKSEPL through MKF and MKI for his individual benefit. According to CIT(A), MKF and MKI were two separate entities; that there was no material to show that MKF and MKI were used as conduits for routing the money from MKSEPL to the assessee. According to CIT(A), while the total investment made by the assessee in purchase of Bonds during F.Y. 1999-2000 was Rs.26.35 crores, the Department has sought to assess only Rs.5.99 crores as deemed dividend and, therefore, according to CIT, the allegation made by the A.O. was baseless. According to CIT(A) there was no material to show that MKSEPL and SCPL had made payments to the said two firms for the benefit of the assessee enabling him to purchase the said Bonds in F.Y. 1999-2000. According to CIT(A), MKSEPL and SCPL were the debtors of MKF and MKI in the regular course of business and, therefore, payments made by MKSEPL to MKF and MKI were repayments of loans and that the said payments were not for purchase of Bonds by the assessee. Accordingly, the appeal was allowed by CIT(A).

G 5. Aggrieved by the decision dated 21.2.03, the matter was carried in appeal by the Department to the Tribunal. By the judgment dated 28.1.05, the Tribunal held that in this case Section 2(22)(e) was attracted since disbursement was made by MKSEPL (company); that SCPL had no independent existence in law in January/February 2000 when payments were made by MKI and MKF  
H to the assessee who bought the said Bonds; that SCPL disbursed Rs.2.04

crores and Rs.75 lakhs in January 2000; that SCPL stood merged in MKSEPL vide Order of the High Court dated 5.7.2001 with retrospective effect, i.e. 18.5.98; that in January 2000 SCPL had no legal existence since the merger had taken place with effect from 18.5.98; that merger had taken place under a voluntary scheme in which every shareholder of the two companies agreed; that, therefore, there was no merit in the contention of the assessee that his shareholding in SCPL and the accumulated profits of SCPL were not liable to be taken into account; according to the Tribunal, in the aforesaid circumstances, all payments should be taken to have originated from MKSEPL; the Tribunal further found that the accumulated reserves of MKSEPL was Rs.55 crores, nearly ten times in excess of Rs.5.99 crores taxed as deemed dividend. It is not in dispute that the assessee had more than 10% of the total voting power in MKSEPL. In the circumstances, the Tribunal took the view that MKSEPL made payment to the said two firms for the benefit of the assessee who thereafter bought the said Bonds. According to the Tribunal, MKSEPL was the only company which made the disbursement through MKF and MKI. According to the Tribunal, it is true that the assessee bought the said Bonds for Rs.26.35 crores but the A.O. had taxed only a fraction of Rs.5.99 crores. However, according to the Tribunal, for the purposes of applicability of Section 2(22)(e) of the said Act payment has to originate from a company. After excluding known company sources, according to the Tribunal, the A.O. was right in restricting the deemed dividend amount to Rs.5.99 crores since known company sources had to be eliminated. According to the Tribunal, the A.O. was right in identifying MKSEPL as the originating company, the identity of the ultimate beneficiary, the amount to be taxed, that is, Rs.5.99 crores and the sufficiency of accumulated profits of MKSEPL in which the assessee had more than 10% voting power. Accordingly the Tribunal allowed the Department's appeal.

6. Aggrieved by the decision of the Tribunal dated 28.1.05, the assessee carried the matter in appeal to the High Court under Section 260A of the said Act. By the impugned judgment the High Court held in favour of the assessee on two counts. According to the High Court, the assessee had declared the primary facts in the Returns. According to the High Court, the present case did not fall under Chapter XIV-B of the said Act. According to the High Court, this was not the case of undisclosed income. According to the High Court, this was a matter of regular assessment. According to the High Court, none of the Authorities below have held that the entries in the books of accounts were fictitious. According to the High Court, full details were disclosed during the block period in the Returns filed by the assessee.

- A According to the High Court, all payments were made by cheque. According to the High Court, moneys were lent and advanced by MKSEPL to MKF and MKI in normal course of business. According to the High Court, the Tribunal had erred in holding that MKF and MKI were conduits for routing the money from MKSEPL through the two firms to the assessee; that there was no evidence in that regard; that the two firms did not have substantial interest in MKSEPL; that there was no evidence to show that payments were made by MKSEPL for the individual benefit of the assessee and to enable him to purchase 9% RBI Relief Bonds; that CIT(A) was right in holding that when Rs.26.35 crores was invested in the above financial year then A.O. had no reason to treat Rs.5.99 crores as deemed dividend under Section 2(22)(e) and
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- C for the above reasons the High Court set aside the judgment of the Tribunal dated 28.1.05. Hence this civil appeal.

7. According to Mr. Mohan Parasaran, learned Additional Solicitor General appearing for the appellant (Department), the High Court should not have interfered with the findings of facts recorded by the Tribunal; that there was no substantial question of law; that no perversity in the findings recorded by the Tribunal so as to warrant interference under Section 260A of the Act; that the Department had searched the premises, it had seized the diary "ML-20" which contained entries subsequently corroborated by cash flow chart which indicated that money had originated from MKSEPL to the two firms through which it had gone to the assessee and, therefore, the Department was right in assessing Rs.5.99 crores as deemed dividend in the hands of the assessee under Section 2(22)(e). Learned counsel urged that the five entries discovered in the search represented five transactions/payments for purchase of 9% RBI Relief Bonds. These, according to the learned counsel, were not repayment of loans, they were payments for purchase of the said bonds during the F.Y. 1999-2000.
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8. On behalf of the assessee (respondent), Mr. N.K. Poddar, learned senior counsel, submitted that the impugned block assessment was wholly without jurisdiction having regard to the fact that the alleged deemed dividend of Rs.5.99 crores relate to transactions recorded and reflected in the regular books and tax records even before the search; that no incriminating document or evidence was found by the Department during the search which falsify such transactions entered into by the assessee in the normal course; that the expression "undisclosed income" has been defined in Section 158B(b) of the said Act and since block assessment was relatable to such evidence recovered during search in the present case Section 158BB(1) was not applicable in this
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case since no such evidence was recovered during the search. Learned A  
 counsel submitted that Chapter XIV-B was put on the Statute Book to enable  
 assessment of undisclosed income detected on evidence found during the  
 search. According to the learned counsel, the block assessment was intended  
 to be an assessment in addition to the regular assessment. Learned counsel  
 submitted that in the present case for want of such evidence, the Department B  
 was not entitled to make additions on account of deemed dividend to the tune  
 of Rs.5.99 crores. During the search, according to the learned counsel, nothing  
 except a cash flow chart giving details of investments made by the assessee  
 in purchase of the said Bonds of the value of Rs.26.35 crores was furnished.  
 According to the learned counsel, the diary "ML-20" was the ledger copy of C  
 the investment account in 9% RBI Relief Bonds which copy was a print-out  
 from the regular accounts of the assessee; that the investment of Rs.26.35  
 crores, reflected in ML-20, was made by the assessee out of his disclosed  
 funds and through regular books of accounts, and that the seized diary did  
 not contain any incriminating information. Learned counsel urged that in  
 the course of block assessment proceedings the A.O. directed the assessee D  
 to furnish details as to the source of funds out of which Rs.26.35 crores was  
 made and when it was explained to the A.O. that the assessee had made such  
 investments in 9% RBI Relief Bonds out of the moneys withdrawn from MKF  
 and MKI and that books of accounts maintained regularly by the said two  
 firms indicated such withdrawals the A.O. directed the authorized  
 representatives of the assessee to prepare a statement indicating the source E  
 from which moneys came in the hands of the two firms and out of which  
 withdrawals were made by the assessee to make investment in the 9% RBI  
 Relief Bonds, therefore, according to the learned counsel, no incriminating  
 material whatsoever was found in the course of the search which could enable  
 the A.O. to invoke Section 2(22)(e) of the Act. According to the learned  
 counsel, in the above circumstance, Chapter XIV-B dealing with block F  
 assessment was wrongly invoked by the A.O.

2. On the nature of the transactions, learned counsel urged that during  
 the F.Y. 1999-2000, the assessee had invested Rs.26.35 crores in the purchase  
 of bonds; that the said investment was made out of the disclosed sources G  
 through cheques and that the said investment was mentioned in the bank  
 accounts and in the tax records of the assessee long before the search.  
 Learned Counsel urged that the immediate source of investment was the  
 withdrawal of Rs.26.35 crores from the partners' capital account with MKF  
 and MKI. It was urged that the cash flow statement was not an admission  
 on the part of the assessee and, therefore, it was not open to the Department H

- A** to invoke Chapter XIV-B. Learned counsel submitted that the Tribunal had erred in holding that the fact that SCPL had a running current account with MKI in the usual course of business, was irrelevant. Learned counsel submitted that SCPL had borrowed substantial amounts from MKI and in January 2000 SCPL repaid Rs.2.79 crores to MKI which were not on behalf of or for the benefit of the assessee. It was urged that MKI had never borrowed money from SCPL at any time. Learned counsel urged that the Tribunal was wrong in holding that the fact that MKI had never borrowed money from SCPL, was irrelevant. Learned counsel urged that Rs.2.79 crores were withdrawn by the assessee from his firm styled MKI on 28.1.2000 and such withdrawal was debited by MKI to the capital account of the assessee. It was urged that
- B** MKSEPL had borrowed substantial amounts from MKF; and MKSEPL had made repayments to MKF during the F.Y. 1999-2000 against the earlier debt owed by MKSEPL to MKF. Learned counsel submitted that the assessee had a credit balance of Rs.6.72 crores in his capital account standing in the books of partnership firm of MKF as on 1.4.1999. Learned counsel urged that the withdrawals made by the assessee from MKF were only out of his capital account with MKF and that the said withdrawals were debited by MKF to the capital account of the assessee. Learned counsel further urged that there was no evidence on record to show that payments by SCPL to MKI and/or the payment by MKSEPL to MKF was for the benefit of the assessee. Learned counsel submitted that payments were made by each of the two companies,
- C** namely, SCPL and MKSEPL to MKI and MKF respectively in liquidation of their respective dues owed by each of the two companies to the said two firms. Learned counsel urged that no payment was ever made by SCPL and MKSEPL to the assessee. Learned counsel urged that the existence of reserves in the balance-sheet of MKSEPL in the sum of Rs.55 crores as on 31.3.1999 is wholly irrelevant for the purposes of Section 2(22)(e) of the Act. Learned
- D** counsel urged that similarly the fact that the assessee owed Rs.8.18 crores to MKI as on 31.3.2000, was wholly irrelevant for the purposes of Section 2(22)(e) of the Act. Learned counsel submitted that Section 2(22)(e) had no application in the matter of the above two facts. Learned counsel urged that the Tribunal failed to appreciate that the assessee did not hold any shares in SCPL on or after 1.4.1999 and, therefore, he did not have any interest in
- E** SCPL on the dates when Rs.2.79 crores were repaid by SCPL to MKI.
- F**
- G**

10. Learned counsel contended that the accumulated profits of MKSEPL could not be treated in law as the accumulated profits of SCPL in spite of the Order dated 5.7.2001 passed by the High Court approving the merger of SCPL with MKSEPL, even when such merger was made effective from 18.5.98.

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Learned counsel submitted that the Tribunal had failed to appreciate that MKSEPL had not merged with SCPL but it is SCPL which had merged with MKSEPL. As a result of the said merger the accumulated profits of MKSEPL did not vest in SCPL. Learned counsel, therefore, submitted that the subsequent event of the Court's Order dated 5.7.2001 approving merger of SCPL with MKSEPL can not enable the Revenue to treat the accumulated profits of MKSEPL as part of the accumulated profits of SCPL. Learned counsel further submitted that MKF never held any shares in MKSEPL. Learned counsel urged that Rs.2.04 crores were paid on 11.1.2000 and Rs.75 were paid on 28.1.2000 by SCPL to MKI. Therefore, according to the learned counsel, if SCPL wanted to declare dividends it could have done so only to the extent of accumulated profits in its own hands and since SCPL on the above two dates could not have declared dividends in excess of its accumulated profits, the Department was wrong in treating the accumulated profits of MKSEPL as accumulated profits of SCPL merely because the merger became effective retrospectively with effect from 18.5.98.

11. We find merit in this civil appeal. The companies having accumulated profits and the companies in which substantial voting power lies in the hands of the person other than the public (controlled companies) are required to distribute accumulated profits as dividends to the shareholders. In such companies, the controlling group can do what it likes with the management of the company, its affairs and its profits. It is for this group to decide whether the profits should be distributed as dividends or not. The declaration of dividend is entirely within the discretion of this group. Therefore, the legislature realized that though funds were available with the company in the form of profits, the controlling group refused to distribute accumulated profits as dividends to the shareholders but adopted the device of advancing the said profits by way of loan to one of its shareholders so as to avoid payment of tax on accumulated profits. This was the main reason for enacting Section 2(22)(e) of the Act.

12. In the case of *Commissioner of Income-Tax, Madras-I v. L. Alagusundaram Chettiar* (1977) 109 ITR 508, the Madras High Court held that the word "payment" in the said section means the act of paying and, therefore, in that case it was held that payment by the company to Karuppiyah Chettiar was for the benefit of the assessee, the Managing Director of the company, L. Alagusundaram Chettiar, and was therefore assessable as dividend in the hands of the assessee. In the said judgment it has been held that the basic test to be applied in such cases is not whether loan given is a benefit but

- A whether payment by the company to Karuppiah Chettiar was for the benefit of the assessee who was the Managing Director of the paying company. Applying the above test to the facts of the present case, we are of the view that the Tribunal was right in holding, on examination of the cash flow statement, that MKSEPL had made payments to MKF and MKI for the benefit
- B of the assessee which enabled the assessee to buy 9% RBI Relief Bonds in the F.Y. 1999-2000. It is in this sense that the Tribunal was right in holding that the two firms were used as conduits by the assessee. It is not in dispute that the assessee had more than 10% of voting power in MKSEPL during the block period. It is not in dispute that the assessee had substantial interest of about 16% in MKF. It is not in dispute that the three companies were the
- C controlled companies. There is one more point which needs to be mentioned. The timing of so-called repayments by the company to MKF and MKI and the immediate withdrawal of the funds by the assessee-cum-Director-cum-shareholder-cum-partner and the timing of investment in purchase of Bonds were around the same time. Moreover, in MKSEPL the assessee is not only
- D a shareholder having more than 10% of total voting power, he is also a Director of that company. The said company is also a partner in MKF and MKI which explains why the amount of Rs.5.99 crores was routed by splitting the said amount into two parts of Rs.2.79 crores and Rs.3.20 crores. In the present case, the most important aspect, which has not been considered by the High Court, was that withdrawal of money by the assessee from his
- E capital account, in the books of MKI, during F.Y. 1999-2000 led to a debit balance of Rs.8.18 crores as on 31.3.2000. To this extent, the finding given by the A.O. and by the Tribunal remains unchallenged. Lastly, on the maintainability of the block assessment, we are of the view that the Department was right in assessing the said amount as deemed dividend in the hands of
- F the assessee under Section 2(22)(e) of the Act. The impugned Assessment Order was passed under Section 158BC. That assessment originated on account of a search conducted under Section 132(1) of the Act. In that search the diary "ML-20" was identified. That identification was the starting point of connected enquiries resulting in the detection of undisclosed income of Rs.5.99 crores. In other words, undisclosed income, in the nature of deemed
- G dividend, did not arise from any scrutiny proceedings, tax evasion petitions, surveys, information received from external agency etc. The undisclosed income was detected by the A.O. wholly and exclusively as a result of a search and, therefore, the Department was right in invoking the provisions of Chapter XIV-B. There is one more aspect in this regard. From the facts, indicated above, the Department has established a sort of circular trading in
- H this case. One of the important features of circular trading is to route the

funds through conduits. In such cases the picture emerges only after seeing the cash flow statements. In the present case, ML-20 made the A.O. to hold enquiries and in that enquiry the cash flow statement emerged, therefore, the Department was right in invoking the provisions of Chapter XIV-B in the present case. The five payments had direct co-relation with Rs.5.99 crores paid by MKSEPL to MKF and MKI and payments by the said two firms to the assessee who used the said money to buy 9% RBI Relief Bonds. Therefore, the said payment by the company through the two firms was for the benefit of the assessee. Therefore, the said funds were not repayment of loans, they were for purchase of 9% RBI Relief Bonds by the respondent.

13. As regards the contention advanced on behalf of the assessee that the accumulated profits of MKSEPL could not be treated as the accumulated profits of SCPL in spite of the Order of merger with effect from 18.5.98, we agree with the view expressed by the A.O. that on merger the accounts of the two companies had merged and, therefore, the reserves had to be taken on the basis of merged account. Moreover, the assessee had substantial interest in MKSEPL right from the inception. Lastly, in the present case, we are concerned with the block assessment which covers the period 1.4.1990 to 24.8.2000.

14. Before concluding, we quote hereinbelow the relevant paragraphs from the judgment of the Calcutta High Court in the case of *Nandlal Kanoria v. Commissioner of Income-Tax, Central, Calcutta* reported in (1980) 122 ITR 405 at p. 415:

“The only question which remains to be considered is that whether the said company made the payments of the said sum of Rs. 75,000 and Rs. 4,80,000 to Indira & Co. for the benefit of the assessee. So far as Rs. 75,000 is concerned it is found by the Tribunal, though not very clearly, that this amount was received by Indira & Co. from the said company and the same amount was given to the assessee by Indira & Co. The Tribunal inferred from the said facts that this was a payment by the said company meant for the benefit of the assessee. This conclusion involves *two findings of fact*, namely, the factum of payment by the company and the motive or intention of the company making such payment, namely, a benefit accruing to the assessee. These are *essentially findings of fact* and have not been challenged by the assessee by an appropriate question.”

(emphasis supplied)

A 15. We also quote hereinbelow para 19 and para 21 of the judgment of the Bombay High Court in the case of *Commissioner of Income-Tax (Central), Bombay v. P.K. Badiani*, reported in (1970) 76 ITR 361:

B "19. Now, the assessee's account for 1st April, 1957, to 31st March, 1958, shows that there are credits as well as debits. What has to be ascertained is whether the debits are "loans", so that they can be deemed as dividends. The account is a mutual, open, and current account. Every debit, i.e., every payment by the company to the assessee, may not be a loan. To be treated as a loan, every amount paid must make the company a creditor of the assessee for that amount. If, however, at the time when the payment is made by the company is already a debtor of the assessee, the payment would be merely a repayment by the company towards its already existing debt. It would be a loan by the company only if the payment exceeds the amount of its already existing debt and that too only to the extent of the excess. Therefore, the position as regards each debit will have to be individually considered, because it may or may not be a loan. The two basic principles are, that only a loan, which would include the other payments mentioned in section 2(6A)(e), can be deemed to be dividend and that too only to the extent that the company has at the date of the payment "accumulated profits" after deducting therefrom all items legitimately deductible therefrom.

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F 21. As regards questions Nos. 3 and 4, Mr. Rajgopal contended that the debit balance, if any, at the last date of the assessee's accounting year 1st April, 1957 to 31st March, 1958, should be taken as the amount to be treated as dividend and as the assessee's account is on the last day to his credit, no amount can be deemed to be dividend. As already pointed out, the position has to be ascertained at the date of each payment by the company to the assessee and this contention must, therefore, be rejected. If Mr. Rajgopal's contention was to be accepted, the result would be that if a shareholder borrows a large amount during the year, but repays it on the last day of the year, it would not be considered to be a loan, though the facts show that he did borrow a loan. Such a contradiction of the real fact would result if Mr. Rajgopal's contention were to be accepted. Mr. Rajgopal further contended that in any event the highest amount to the assessee's debit on any day of the year should be the amount to be deemed to

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be dividend. This argument, again, ignores the principle laid down by us, that the position at the date of each payment must be considered. Moreover, there is another reason and that is that if it were to be so done, it would not enable the position of the balance of the "accumulated profits" being taken into account, as more than one shareholder may have borrowed loans from the company in an account similar to that of the assessee. All these contentions of Mr. Rajgopal ignore the *basic fact that section 2(6A)(e) uses the words "any payment" which means, every payment, and section 2(6A)(e) requires the determination of two factors, viz., whether the payment is a loan and whether at the date when the payment is made there were "accumulated profits" and that these two factors are to be correlated and the result must be ascertained at the date of each such payment.*

*(emphasis supplied)*

16. The above two judgments indicate that the question as to whether payment made by the company is for the benefit of the assessee is a question of fact. In this case, the Tribunal has concluded that the payment routed through MKF and MKI was for the benefit of the assessee. This was a finding of fact. It was not perverse. Therefore, the High Court should not have interfered with the said finding. Further, the above two judgments lay down that the concept of deemed dividend under Section 2(22)(e) of the Act postulates two factors, namely, whether payment is a loan and whether on the date of payment there existed "accumulated profits". These two factors have to be correlated. This correlation has been done by the Tribunal coupled with the fact that all withdrawals were debited in the capital account of the firm leading to the debit balance of Rs.8.18 crores. The High Court has erred in disturbing the findings of fact.

17. For the above reasons, we set aside the impugned judgment of the High Court. Accordingly, the appeal stands allowed with no order as to costs.

VS.

Appeal allowed.