Disguised Distributions: A Primer on Taxation of Dividend Distributions to Shareholders by Corporations

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I. INTRODUCTION: DOUBLE TAXATION OF CORPORATE PROFITS

A company, as opposed to partnership, is a legal entity and is taxed separately from its shareholders. This means that if a company makes any profits, subject to permissible deductions, such profits shall be taxable at the applicable rates. Shareholders, who are the owners of the company, and on whose behalf the directors and management of the company are struggling to earn profits, would usually want those profits to be distributed to them. However, if the company does distribute those profits to its real owners (shareholders), the said distribution is taxed again – this time as income of the shareholders (not the company's). This distribution by a company to its shareholder out of the current or accumulated profits[1] is known as 'dividend'[2]. A 'distribution' in terms of income tax law is understood to

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[1] The term 'accumulated profits' in relation to distribution or a dividend has been defined in Income Tax Ordinance 2001 (hereinafter cited as ITO 2001), § 2(1) as:

> "(a)any reserve made up wholly or partly of any allowance, deduction, or exemption admissible under this Ordinance; (b)for the purposes of [1][sub-clauses (a), (b) and (e) of clause (19)"] all profits of the company including income and gains of a trust up to the date of such distribution or such payment, as the case may be; and (c) for the purposes of **[sub-clause (c) of clause (19)], includes all profits of the company including income and gains of a trust up to the date of its liquidation."

This is in marked contrast to the practice of other jurisdictions where the policy makers are reluctant to define the term 'accumulated profits' and rather prefer to keep it general. Perhaps this is why the term 'earnings and profits' has been used in many countries including USA and UK for taxing distributions as dividends.

[2] The term dividend has been defined in ITO 2001, § 2(19) and means to include:

> Any distribution by a company of accumulated profits to its shareholders, whether capitalised or not, if such distribution entails the release by the company to its shareholders of all or any part of the assets including money of

mean a distribution of an asset, money or other gain being capable of translation into money, to the shareholders of a company.

In this context, double taxation would mean lesser profits for the shareholders. This perhaps is one of the very few disadvantages of incorporation. Some policy makers argue that double taxation can be taken as a premium charged by the government for allowing limited liability. It is also argued that since company is a separate legal entity, it is capable to own its own legal attributes – one of them being, taxation of earnings and profits.

A partnership on the other hand, is not a legal entity; it does not afford a limited liability protection[3] (at least in Pakistan) and it is also not taxed separately from its owners. For various reasons, however, an entrepreneur or an investor would still usually prefer to invest in a company rather than a partnership. But at the same time, he/she would like to find a way through which he/she can escape double taxation. This would be especially true if the said investor has a substantial stake in the company, and a 10% extra tax would translate into millions of rupees. A small investor on the capital

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> the company; (b) any distribution by a company, to its shareholders of debentures, debenture-stock or deposit certificate in any form, whether with or without profit, *[ ] to the extent to which the company possesses accumulated profits whether capitalised or not; (c) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not; (d) any distribution by a company to its shareholders on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether such accumulated profits have been capitalised or not; or (e) any payment by a private company **[as defined in the Companies Ordinance, 1984 (XLVII of 1984)] or trust of any sum (whether as representing a part of the assets of the company or trust, or otherwise) by way of advance or loan to a shareholder or any payment by any such company or trust on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company or trust, in either case, possesses accumulated profits.

This definition is almost an exact replica of the corresponding Indian Tax Law provision. Apparently, this and most other provisions are based on the IMF model for the developing countries, which explains why it is so different from the relevant provisions of USA and UK.

[3] Limited liability partnerships and certain pass-through hybrid entities (not recognizable for taxation purposes) allow limited liability protection as well as a pass-through treatment for taxable profits. In Pakistan, this model has not yet been adopted. Even the single member companies in Pakistan are not given any incentive in the shape of pass-through treatment, and as such are taxed as private companies. Therefore, sole proprietors have no incentive to incorporate and formalize the economy. The concept of pass-through etc. would be the subject of subsequent deliberations by the author.

markets, though, would care less if he/she has to pay 10% of his/her few thousand (or hundred) rupees of the dividends.[4]

II. 'CURRENT PROFITS' & 'ACCUMULATED PROFITS'

In this context the terms, 'earnings and profits' (or E&P) and 'current' or 'accumulated profits'[5] are of marked significance. There can be no dividend distribution if the company does not possess 'earnings and profits' or 'accumulated profits' or 'current profits'. If for instance, a company does not have any reserves of current or accumulated profits, and it proceeds to distribute money or property to its shareholders, the same would most likely be a return of capital and not dividend. Return of capital would then be taxed under the capital gains rules. However, if the company possesses current or accumulated profits, any distribution – whether called return of capital etc. – shall in most cases be considered to be a dividend distribution.

In many developed countries, incentives are given to allow a company to capitalize its earnings and profits without paying any tax. In other words, retained earnings are not taxed as such unless they are distributed. In Pakistan, however, there is no incentive for a company to capitalize its earnings and invest the same again for the benefit of the company.[6] Any and all the profits are taxed in Pakistan, and there is no exemption or deferment for retained earnings or capitalization for re-investment. This practice mars the re-investment of capital by the companies, which ultimately leads to tax distortions. A simple example of this distortion is as follows:

When an investor or entrepreneur invests in a start-up company, such investment is neither taxed at the hands of the investor nor at the hands of the company. Nevertheless, such company does earn capital gain when the assets or the investment that is contributed by the investor increases in value. In effect, this start-up company has been granted a deferment in taxation, so that whenever the investment is returned for profits or in the shape of returned capital, tax implications would at once arise. However, in the case of an existing company, which is trying to make use of its profits for further investment, would be taxed twice for the same profits – once at the hands of the company and again when the same is capitalized and an appropriate share or debenture is issued to the investor to that effect. So comparing both situations, we see that the already existing company would lose significant amount of money for the same investment which would be

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[4] ITO 2001, § 5. According to the § 5 when read with Division III of Part I of the First Schedule of the ITO, the rate of tax on dividend is, i) in case of dividend received by a public company or an insurance company, 5% of the gross amount of dividend, and ii) in any other case, 10% of the gross amount of dividend.

[5] Ibid at § 1.

[6] Id. at § 2(19)(a).

free for the start-up company. Such a tax distortion would ultimately effect the competition in the market.

III. DISGUISED DISTRIBUTIONS

Disguised distributions are engineered to help the former category of investors. Through disguised distributions, shareholders are able to extract reserves and accumulated profits out of the company, in various forms, so that the same is not taxed again. Tax authorities of U.K and the USA have struggled for decades with the menace of disguised distributions and based on their experiences, they have come up with various rules that are designed to net the evasion of taxes on dividends through disguised distributions.

In Pakistan too, corporate profits are taxed twice, once at the hands of the company and again at the hands of the shareholders when those profits are distributed to the shareholders as dividends. Pakistan seems to have taken advantage of the experience of both UK and USA. The revenue service of Pakistan has adopted almost the same rules, in a very crude form though, to prevent disguised distributions to the shareholders of companies.

Apart from other measures that have been taken by the government to discourage the use of disguised distributions, which we shall discuss below, the effective rate of tax for distribution of corporate profits has been markedly reduced. The rate of tax for a public limited company is 35%, while the rate of tax for a private limited company is 41% for the year 2004-2005. The rate of tax for an individual would vary according to the annual income such individual would earn, however, the same does not exceed 35% in any case. Now, a double taxation on corporate profits in normal circumstance, at least, would be 35% (on corporate profits) + 35% (on distribution). The effective rate in such case for once individual would be at least 70%. By any standard a 70% tax rate would discourage investment in corporate form of business, and perhaps encourage disguised distributions. In order to counter these problems, government has reduced the tax on dividends to 5% if the divided is derived by a public company or an insurance company, and to 10% if the dividend is derived by a person in any other case. A 5% and 10% second tier tax on corporate profits seems to be sustainable. However, for an investor with substantial stakes, whereby 5% or 10% tax on distributions would translate into millions of rupees, looking for ways to disguise distributions still remains very important.

Dividend treatment, as we have seen, is not only undesirable to shareholders it may also adversely effect the company. After all, the dividend would be tax at the hands of the shareholders, and corporation would not even get a deduction for such a distribution. How about finding a way whereby if the shareholder gets taxed on that distribution, the corporation gets a deduction for such distribution. Alternatively, what if when a company makes a distribution it does not get any deduction but the

shareholder is not taxed on such distribution. Finally, the best of all the worlds i.e. what if a company makes a distribution and gets a deduction and the shareholder does not get taxed.[7] All three of these situations escape the double taxation one way or the other.

There is no shortage of ways to disguise a dividend distribution as non-dividend distribution. However, almost all of the creative ways seems to fall under one of three prototypes. First, the distribution might be disguised as a deductible expense, while at the same time the receipt by the shareholder would be taxable.[8] This type of distribution eliminates the tax at the corporate level by allowing a deduction thereby such distribution would not be included in the corporate earnings resulting in lowering of taxes. The second prototype is a distribution which is excludable or non-recognized at the hands of the shareholders but no deduction is allowed to the company – meaning that such distribution is included in the company's taxable earnings. This type of distribution eliminates the shareholder level tax. The third prototype is a distribution that is included in the deductions allowed to the company and then is also not taxed to the shareholder.

IV. STATUTORY CONTROLS ON DISGUISED DISTRIBUTIONS

A. *Section 2(19)(a) of Income Tax Ordinance*

Any distribution by a company of accumulated profits to its shareholders, whether capitalized or not, if such distribution entails he release by the company to its shareholders of all or any part of the assets including money of the company.[9]

At first sight this may seem to be an all-encompassing provision, which provides that a dividend would include any distribution by a company of accumulated profits to its shareholders. A distribution must meet two conditions in order to become deemed dividend[10] under section 2(19)(a),

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[7] To appreciate these three prototype situations, one must understand the concept that a deduction at the hands of a corporation for the purpose of computing taxable income of the corporation would ultimately increase the profits of the company and those profits belong to the shareholders. Therefore, shareholders have incentive to structure the transaction in a way that would enable the company to claim deduction of the distribution to the shareholder.

[8] In corporate tax parlance, the taxability of a distribution at the hands of the shareholder is known as a recognized transaction. Non-recognition treatment, therefore, means a transaction which is not recognized by the income tax or in other words is tax free.

[9] See ITO, § 2(19)(a).

[10] The term deemed dividend is used to signify a distribution which is not a dividend distribution as such but is declared dividend distribution to take into account the accumulated profits of the company.

which are; 1) that it must be a distribution of accumulated profits, whether capitalized or not, and 2) it must entail release of cash or other assets of the company. Suppose a company release a car to its shareholder with a market value of Rs. two million. Now suppose that the company has accumulated profits of Rs. two million as well. Under this provision, the release of car by the company to its shareholder would be taxable as dividend. The question now is, what must be the value of the car. Whether it is book value of the car at the hands of the company? Or whether it should be the market value the car can fetch in the market? The law says it should be the fair market value of the asset.[11] Therefore, the difference between the book value and the fair market value of the asset is the realized gain at the hands of a corporation which shall be taxable. It means that a distribution by a corporation of an asset to its shareholder to the extent of its accumulated earnings, would not only be taxable to the shareholder, but also to the company – a bad move in terms of tax planning.

1. *Issuance of Bonus Shares – Whether taxable as dividend?*

Bonus shares are typically issued once the accumulated or current profits of the company are capitalized and converted into capital. *Capitalization* means "*the conversion of company's profits or income into capital by resolution of a company*".[12] A company may capitalize its profits, if its articles so allow, instead of dividing and distributing them to its shareholders. This is done by applying such profits in paying up the un-issued shares, or debentures or other securities and issuing such fully paid securities to its members. Under Pakistani law[13] distribution of debentures or debenture stocks is a taxable dividend distribution transaction. However, there is no provision that expressly declares distribution of bonus shares as a dividend. Therefore, when a company capitalizes its profits and subsequently issues fully paid up bonus shares to its shareholders, it presumably is a non-taxable event. Although these shares do carry a taint of profits in them, but whenever they are sold they will be taxable under the capital gains rules and not under the dividend rules. Capital gains derived from the sale of securities of *modarba* companies or a public company is exempt from tax.[14] Assuming for a moment that bonus shares can be issued and distributed to the shareholders avoiding the dividend tax, and those bonus shares are later sold in the market without any capital gains tax – shareholders can successfully avoid imposition of 5% of dividend tax to the extent of the par value of the bonus shares – the remaining portion of the earnings, if any, are already exempt.

[11] See ITO, § 76(3).
[12] Dictionary of English Law, Vol. 1.
[13] See ITO, § 2(19)(b).
[14] See ITO, Second Schedule, Part I, clause 109.

House of Lords while examining this issue expressly held that *"bonus shares issued by a company in exercise of the power under the articles of association are not dividend and therefore not income of the shareholder".*[15] There have been many statutory changes in UK since. However, Indian Courts have continued to follow this principle. In 1971, Supreme Court of India held that *"bonus shares given by a company in proportion to the holding of equity capital by a shareholder are, in the absence of any express provisions to the contrary, liable to be treated as capital and not as income"*. In fact there is no express provision to the contrary in the Indian Income Tax Law, and consequently in Pakistan, which has adopted exactly the same provision relating to dividend distribution, the same rule would be applicable and bonus shares could be issued without invoking the provisions of deemed dividend distributions.

2. *Release of Assets without Title*

Clever tax planner can create variety of ways in which a particular provision may be dodged. There may be a situation where an asset is released to a shareholder, and instead of getting taxed as deemed dividend the transaction gets a deduction at the hands of a company, despite having accumulated profits. In principle such transaction should fall in the net of deemed dividend distribution. Assume that a company rents a BMW for use by one of its major shareholders for official purposes. In fact, that shareholder loves to use that BMW model and was thinking of replacing his old one. If a company purchased the said BMW for the shareholder, it would have been taxed at the fair market value as deemed dividend. Alternately, if the company provided that car to its shareholder for personal use as a perk, the same would have been taxable under the Salary/Perquisite Rules. However, in this situation the company has rented the BMW from a car rental company on an on-going basis and provided the same to the shareholder for certain specified (read unspecified) use. The shareholder now gets to use a BMW which it wanted to buy, and escapes the tax liability under both the deemed dividend or salary provisions, and at the same time the company gets a huge rental deduction from its operating income. This deduction, of course, would ultimately find its way into the pockets of the shareholders.

[15] *CIR vs. John Blott*, 8 TAX CASES 101 (1921).

B. *Section 2(19)(b) of Income Tax Ordinance*

Any distribution by a company, to its shareholders of debentures, debenture-stock or deposit certificate in any form, whether with or without profit, to the extent to which the company possesses accumulated profits whether capitalized or not.[16]

This provision is designed to net the disguised distribution of accumulated profits by distributing obligatory notes from the corporation to the shareholder. The synopsis of issuance of debentures, bonds or debt instruments is as follows: a company having accumulated profits and wishing to capitalize those profits and perhaps re-invest in its corporate activities may issue debentures (corporate bonds or debt instruments) to its shareholders in proportion to their shareholding to the extent of dividend due to be payable to the shareholders.[17] These debentures are redeemable by the shareholders. The profit (or mark-up) paid by the Company on such instrument is deductible from its profits as amounts paid for debt servicing, since the same is a loan from the shareholders to the corporation.[18] A debenture may be issued both for cash and in lieu of distribution of accumulated profits. One that is issued for cash, of course, shall be taxed under the profit on debt provisions. On the other hand, a debenture issued in lieu of distribution of accumulated profits is loaning of accumulated profits back to the company, and not only that the profit received on such debentures would be taxed under the profit on debt provisions, but the distribution of the debentures itself would be taxed as dividends.

C. *Section 2(19)(c) of Income Tax Ordinance*

Any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalized or not.[19]

Liquidation is a distribution of a company's assets in complete cancellation of all out-standing stock, subject to the satisfaction of claims by

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[16] See ITO, § 2(19)(b).

[17] Distribution of dividend in cash may not be feasible for a company for want of cash flows. Notice that there are two ways to retain the earnings by a corporation – either by issuing additional shares to reflect retention of profits and its conversion into capital, or by issuance of debentures whereby converting the share of profits of the shareholders into a loan given by the shareholders to the company, avoiding a distribution of cash.

[18] One reason why a company would prefer issuing debentures over bonus shares is that the company can deduct payments on the debentures as expenditure – while payments of dividends on the bonus shares are not deductible.

[19] ITO, § 2(19)(c).

all the charge holders. There is no requirement that liquidation distribution must be in the form of cash. The company may also distribute its assets among its shareholders. Upon liquidation, the assets of the company are sold, and from the cash received, the claims of various charge holders and debtors are satisfied according to their priorities. Once all the claims are satisfied, including the claims of the preference shareholders on their accumulated dividends, or the claims of the holders of convertible securities – the remaining amount, if any, must be distributed to the common stock holders in proportion to their stock holding.

It may seem to be a return of capital at the first instance. However, the component of accumulated profits that the company possessed before dividend is not a return of the capital. A return of capital – absent any capital gains – ordinarily should not be taxable to the shareholders.[20] Assume that accumulated profits component of a liquidation distribution is not taxable. Could it be that controlling shareholders may want to retain the profits in anticipation of liquidation so that the profits can be taken out tax free in the garb of return of capital? Or perhaps as capital gains (assuming better rates of taxes on capital gains)? To prevent such happening, clause (c) makes a liquidation distribution taxable as dividend to the extent of the portion that is attributable to accumulated profits immediately before such liquidation.

Assume that a company has incurred substantial capital losses at the time of liquidation.[21] However, despite suffering capital losses, the company held a reserve of accumulated profits immediately before the liquidation. What must be the treatment in this case? Should the shareholders be allowed to ignore the accumulated profits and offset the same with the capital losses the company (and consequently they) have suffered? In one such case, Bombay High Court has held that *"even if an assessee has incurred loss by subscribing to the capital of the company and may have, in the distribution of assets in liquidation, received much less than the capital subscribed, the distribution on liquidation, in whatever form it may be made, is taxable as dividend to the extent it is out of the accumulated profits of the company"*.[22] Therefore, it is possible that a shareholder suffering a huge loss at the time of distribution of assets pursuant to liquidation may be taxed for receiving dividends (pun intended).

However, notwithstanding the aforesaid, a distribution which is return of capital, distribution of shares that are fully paid, or redemption of debentures or debenture stocks is not taxable as a dividend.[23] A condition precedent for

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[20] See generally ITO, § 37.

[21] One can imagine it to be a common feature, since mostly liquidations are conducted through auctions and the real value is hardly obtained from the assets through such auctions.

[22] *Vidyutrai Y. Desai vs. CIT*, 33 ITR 510 (Bom).

[23] See ITO, § 2(19) proviso (ii).

the application of this exemption is that in case of liquidation the share, debenture or debenture stock must not have any right to participate in the surplus assets of the company.[24] The reason for this provision is that holders of those instruments who cannot participate in the surplus assets[25] have no incentive to disguise profits until liquidation and receive their dividends in various forms, since they have limited rights – and mostly their rights are limited to dividends only.[26]

D. *Section 2(19)(d) of Income Tax Ordinance*

Any distribution by a company to its shareholders on the reduction of its capital, to the extent to which the company possesses accumulated profits, whether such accumulated profits have been apitalized or not.[27]

1. *Taxation of Redemption Distributions*

Many different issues are involved in distributions upon redemption of capital. We know now that return of capital is not taxable as such unless accompanied by a built-in gain.[28] An old technique that was frequently used by closely held companies (private companies) was that in the event of profits the company typically decided to reduce its capital. To accomplish this goal, a distribution was made to all the shareholders signifying a distribution of return of capital. In effect, what we had was that notwithstanding the reduction of the capital and return of the same by way

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[24] A share that does not have a right to participate in the surplus assets, in case of liquidation is known as a simple preferred stock. A preferred stock that has the right to participate in the surplus assets in case of liquidation is known as participatory preferred. Through some careful drafting, a simple preferred stock would look very similar to a bond or TFC or debenture. In fact, because of little or no difference, clever tax planners use this instrument for various tax planning purposes including dual use whereby such instrument would be declared a debenture where a deduction is in order, and a equity instrument where need be. Little or no case law exists in both Pakistan and India which prescribe any conditions that differentiate a simple preferred stock from debentures.

[25] After the claims of the creditors, debenture/TFC holders, and preferred stock holders have been satisfied, common stock holders, upon liquidation, are entitled to return of their capital. Any surplus that is left is distributed among the common stock holders, which is generally subject to capital gains treatment. Simple preferred stock is only entitled to return of capital plus any guaranteed dividend still due.

[26] Tax authorities may well look out for convertible securities that apparently have fixed dividend rights and are either preferred shares or debentures but convert into participating equity upon liquidation.

[27] ITO, § 2(19)(d).

[28] See generally ITO, § 37.

of distribution, actual interest of the shareholders remained the same. It means that each shareholder continued to enjoy the same proportion of ownership in the company accompanied by the same rights in the affairs of the company including the right to receive similar dividends. So what actually happened was that an amount was taken out of the company without actually reducing or affecting the rights of any of its shareholders.[29]

This provision is designed to net the disguised distributions of assets or money in the garb of reduction and return of capital to the extent of the accumulated profits possessed by the company. In case of a distribution of an asset instead of cash, where the value of the asset is more than the accumulated profits of the company, dividend would be deemed only to the extent of the accumulated profits, and the remaining portion shall be applied towards return of capital.[30]

2. *Issues & Problems with the Provision*

a. *Proportionate and Disproportionate Distributions*

The concept of proportionate and disproportionate redemptions is also relevant here. Assume that shareholder A & shareholder B own 50% of ordinary shares each in AB Ltd. The capital invested by both shareholders is Rs. 100 each, making a total capital investment of Rs. 200. Now suppose that after two years AB Ltd. has Rs. 100 in accumulated profits. AB Ltd. thereafter reduces its capital to Rs. 100 and returns the excess Rs. 100 back to shareholders A & B. Both shareholders A & B have received Rs. 50. At the moment both have 50% of the share in AB & Co. (despite the reduction in capital), but in effect they have stripped AB & Co. of Rs. 100 in accumulated profits, tax free, which still remains with the company and can be used instead of Rs. 100 returned as capital.[31]

Alternatively, suppose that instead of redeeming shares of both shareholders A & B, AB Ltd. redeems shares of shareholder A to the extent of Rs. 50. What has happened now is that shareholder A's percentage of ownership has come down to 25% and the percentage of ownership of shareholder B has gone up to 75%. Should this transaction also be taxed under the reduction of capital rules? It is clear in this case that the interest of one shareholder has been reduced as opposed to the other shareholder and to that effect the transaction is genuinely return of capital to the shareholder A. Why must that be taxed as dividend. Same would be the case if distribution

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[29] Explanation: A shareholder would care less if he has 50 shares of a company or 100 shares of a company as long as he owns 50% of a company either way, and gets the same rights as before.

[30] *CIT vs. G. Narasimhan,* 118 ITR 60 (MAD) (1979).

[31] Transactions in which interests of all the shareholders are reduced in the same proportion are typically known as proportionate distributions.

to shareholder A was in complete termination of his interest (as opposed to the partial termination just discussed).[32]

b. *Redemption of Participating Preferred Stock (Shares)*

Another problem that can potentially arise under this provision can be explained from the following example. Assume that a company is in need of further capital to keep it as a going concern. Further assume that market is unwilling to finance the company either through debt or equity investment. Suppose that shareholder A of this company agrees to inject additional capital, which the company badly needs, in the form of Series A Participating Preferred Stock. To accomplish this goal, the shareholder A purchases 500 shares of Rs. 1,000 par value preferred stock (total investment of Rs. 500,000). Since this was an emergency situation and the shareholder made this additional equity investment to save the company from bankruptcy, therefore, it was the understanding that the preferred shares would be redeemed once the company is out of trouble.

Suppose that after six months the company manages to stabilize and posts a profit of Rs. 1,000,000/-. As per the understanding, the company redeems the preference shares of shareholder A at par and returns him his Rs. 500,000/- investment and the shareholder A reported this transaction as tax-free return of capital. Under section 2(19)(d), this transaction can be a dividend distribution since the company possesses accumulated profits of Rs. 1,000,000/- and apparently does not fall in the exemptions given in proviso to section 2(19).[33] The Supreme Court in *United States vs. Davies*[34] held that since the company had adequate earnings and profits, it was includable as dividend distribution and not the return of capital.

The result in this case would be unjust under the present rules. Pakistani law very clearly would tax this transaction as a dividend distribution whereas it is simply an attempt to finance the company in the time of need, and as such the shareholder is entitled to the return of capital once the need is over – as per the agreement. The situation would definitely be changed if shareholder A was a substantial shareholder of the company, and this technique in that case could definitely be used to bail out accumulated profits in the garb is redemption of preferred stock. This technique – mostly used by closely held or private companies – is commonly known as a

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[32] Transactions wherein interest of one shareholder is either completely terminated or partially reduced in comparison to other shareholders is typically known as disproportionate distribution. Subject to some qualifications and conditions, these are not likely to be dividend distributions in many countries.

[33] The proviso (i) of the section states that the term dividend does not include "a distribution in accordance with sub-section (c) or (d) in respect of any share for full cash consideration or redemption of debentures or debenture stock, where the holder of the share or debenture is not entitled in the event of liquidation to participate in the surplus assets."

[34] 397 U.S. 301 (1970).

preferred stock bail-out. In the context of a preferred stock bail out, this provision definitely makes sense and is an effective tool to prevent such disguised distribution transactions.

At the same time, this provision signifies the extreme discrimination which corporate equity faces as compared to corporate debt. In a genuine *Davies* transaction, investment in the form of equity and subsequent redemption at par value would be slapped with dividend taxation, whereas if the same transaction was accomplished by way of debt financing (in the form of purchase of debentures) it would fall under the exception to the deemed dividend provisions[35] and, therefore, would be exempt from any deemed dividend. Such preference for debt over equity is laid out all over the Income Tax Ordinance 2001, which in macro numerical terms ultimately creates tax distortions.

E. *Section 2(19)(e) of Income Tax Ordinance*

Any payment by a private company or trust of any sum (whether as representing a part of the assets of the company or trust, or otherwise) by way of advance or loan to a shareholder or any payment by any such company or trust on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company or trust, in either case, possesses accumulated profits.[36]

This provision only applies to private companies mainly because public companies have their own mechanism to advance loans to its shareholders and directors, which ensure that none of the profits of a public company goes out of the company as a disguised payment, never to be returned.[37] This provision is designed to combat an earlier practice that was very successful in disguising dividends. Typically, a company, being a closely held company, made a loan or an advance to a controlling shareholder, which reduced the profits (either taxed or untaxed) of the company to be distributed. A loan, of course, without applying the fiction of this provision, would not be taxable to the shareholder, if there is a way to ensure that the same would be returned and an adequate prevailing interest rate would be paid by the shareholder to the company during the term of the loan. Unfortunately, however, for a private company it is very difficult to do so mainly because the shareholder receiving the loan would most likely be a

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[35] Proviso (i) of § 2(19) which specifically excludes redemptions on debentures and debenture stocks.

[36] ITO, § 2 (19)(e).

[37] The relevant Indian Income Tax provision from where this has been adopted deals only with shareholders who have substantial interest in the company – a majority shareholder or a shareholder associated with a majority group.

controlling shareholder (or associated to a controlling shareholder) and directly influence the management of the company. In such circumstance it is highly likely that the loan would not be returned, or would be forgiven. If that happens, the shareholder would receive a tax free benefit from the company without paying any dividend taxation.

It seems that the Pakistani Income Tax Law presumes that a minority shareholder will not get a loan or an advance from a private company. Majority of the jurisdictions have patterns similar to Indian model limiting the scope of application of this provision to shareholders having substantial interest in the company or shareholders associated with a majority group. A loan or advance made to a shareholder in regular course of its business is also not accounted for. Hence, a shareholder in genuine need of an advance or loan would be unable to avail any facility from the company because of dividend tax implications.

Interestingly, this provision also does not qualify itself by the expression *"whether capitalized or not"* that is used in other sub-sections of S. 2(19). It means that if all the accumulated profits of a private company are capitalized in anticipation of a proposed advance or loan, and thereafter a loan or advance is made out of such capital reserves, the same would be a possible tax-free distribution.

Another potential problem with this provision is that it does not account for a situation where a shareholder who takes a loan and returns the same in the same tax year or the year immediately after the tax year and also pays adequate interest on it. For lack of an exception or a proviso, such situation is likely to be taxed as a dividend even though the same has been returned.

This provision also discourages cross-corporate financing among closely held private companies of the same group. Shareholder in this case would also include a corporate shareholder. Therefore, a sister company A having shareholding interest in the Company B would not be able to receive any kind of finance facility or the same may be taxed as a dividend. Cross-corporate financings are very common in private companies. It is also not clear whether a cross-corporate guarantee to a sister company for securing a loan from Bank would trigger deemed dividend provision.

V. THE BEGINNING

There is a constant struggle on part of the companies to reduce their tax liability, thereby making it more profitable for their shareholders. A public company having greater annual profits and low tax liability on their annual statements would look good on the stock market. A private company on the other hand would directly benefit, as the money saved from tax net would go directly to the shareholders, usually a close group of people. Difference between tax rates on various forms of distributions is the primary reason why a company would engage in tax planning and creating tax shelters. A

low dividend tax vis-à-vis a high capital gains and corporate tax would lead to attempts by companies to disguise, as much as possible, any distribution as a dividend – to avail better rates for the shareholders. On the other hand, a low capital gains tax vis-à-vis a high dividend tax would compel the companies to disguise dividend distributions as return of capital.

Rates of dividend taxation on distributions made by resident companies have been markedly reduced, thereby reducing the possibilities of misusing the loop holes in the tax law for disguising dividend distribution. However, a careful tax planning and perhaps a need to figure out ways of disguising distributions is still very much relevant and important of non-resident companies – whose rate of tax on dividend is governed by the relevant double taxation treaty.

Leaving problems and issues aside for a moment, promulgation of the new income tax law is a beginning of a new era for Pakistan. Where taxation forms the backbone of any country's social, commercial and defense obligations, the Income Tax Ordinance, 2001 is one step forward in streamlining and rationalizing the tax system of Pakistan.