IN THE HIGH COURT OF PUNJAB AND HARYANA AT CHANDIGARH

ITA No.185 of 2013
Date of decision: 1.10.2015

Commissioner of Income Tax, Jalandhar I, Jalandhar
……Appellant

M/s Max India Limited

…..Respondent

CORAM: HON'BLE MR. JUSTICE AJAY KUMAR MITTAL
HON'BLE MR. JUSTICE RAMENDRA JAIN

1. Whether Reporters of local papers may be allowed to see the judgment?
2. To be referred to the Reporters or not?
3. Whether the judgment should be reported in the Digest?

Present: Mr. Vivek Sethi, Advocate for the appellant-revenue.
Mr. Ajay Vohra, Sr. Advocate with Mr. Gaurav Jain, Advocate for the respondent.

Ajay Kumar Mittal,J.

1. The appellant-revenue has filed this appeal under Section 260A of the Income Tax Act, 1961 (in short, "the Act") against the order dated 8.3.2013, Annexure A.3 passed by the Income Tax Appellate Tribunal, Amritsar Bench, Amritsar (in short, "the Tribunal") in ITA No.78(Asr)/2006 for the assessment year 2001-02, claiming following substantial question of law:-

> "Whether the ITAT has erred in law and in facts in holding that no disallowance can be made under section 14A unless a clear cut nexus is established between the expenses disallowed and income earned ignoring the fact that both direct and indirect

expenses are attributable to such investment?"

2. A few facts relevant for the decision of the controversy involved as narrated in the appeal may be noticed. The assessee company is in the business of manufacturing of pharmaceuticals, health care services etc. It is deriving its income from marketing of biaxially oriented polypropylenes (BOPP) firms etc.- a flexible packaging material. The assessee company filed its return on 30.10.2001 declaring loss of ₹ 28,67,15,815/- and book profit of ₹ 4,21,61,953/- under section 115JB of the Act which was processed under Section 143(1) of the Act. The case of the assessee was taken up for scrutiny. Notices under Sections 143(2)/142 (1) of the Act were issued to the assessee. Assessment in the case was completed under section 143(3) of the Act by the Assessing Officer on 30.3.2004 at assessed income under section 115JB of the Act after setting off of brought forward losses. The Assessing Officer while making assessment made the following additions/disallowances:-

Disallowance of expenses on account of earning of exempt income.

The AO has disallowed ₹ 1.50 crore as expenses apportioned for exempt income taking into account the extent of investment of the assessee and expenses in the corporate sector as the deduction is not allowable in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. Copy of the order of assessment under section 143(3) of the Act dated 30.3.2004 is annexed as Annexure A.1. Aggrieved by the order, the assessee filed appeal before the Commissioner of Income Tax (Appeals) [CIT(A)]. Vide order dated 19.1.2006, Annexure A.2, the CIT(A) partly allowed the appeal and restricted the addition/disallowance made by the Assessing Officer under Section 14A of the Act to ₹ 10 lacs only and deleted the addition of ₹ 1.40 crores. Still not satisfied, the assessee filed appeal before the Tribunal. The revenue also filed appeal against the order of CIT(A) before the Tribunal. Vide order dated 8.3.2013, Annexure A.3, the Tribunal allowed the appeal of the assessee and dismissed the appeal filed by the revenue. Hence the instant appeal by the revenue.

3. We have heard learned counsel for the parties.

4. Learned counsel for the revenue submitted that the order passed by the Tribunal is illegal and perverse in holding that no disallowance could be made under Section 14A of the Act unless a clear cut nexus was established between the expenses disallowed and the income earned. Reliance was placed upon judgment of the Apex Court in ***Commissioner of Income Tax vs. Walfort Share and Stock Brokers P. Limited,*** (2010) 326 ITR 1.

5. Learned counsel for the assessee relied upon ***CIT vs. Metalman Auto P. Limited***, (2011) 336 ITR 434 and ***CIT vs. Hero Cycles Limited,*** (2010) 323 ITR 518 to submit that the revenue was under obligation to show that certain definite expenditure was claimed by the assessee in respect of which the income of the assessee was exempt. In the absence of the same, no expenditure could be disallowed on estimate basis. It was further submitted that sub section (2) of section 14A was introduced by Finance Act, 2006 w.e.f 1.4.2007 and in pursuance thereto Rule 8B of the

Income Tax Rules, 1962 (in short, “the Rules”) was notified by the Central Board of Direct Taxes (CBDT) with effect from 24.3.2008. Relying upon judgments of Delhi High Court in ***Maxopp Investment Limited vs. Commissioner of Income Tax, New Delhi,*** (2012) 347 ITR 272 and Bombay High Court in ***Godrej and Boyce Mfg. Co. Limited vs. DCIT and another***, (2010) 328 ITR 81, it was submitted that sub section 2 of Section 14A of the Act and Rule 8B of the Rules have been held to be prospective.

6. The solitary issue that arises for consideration in this appeal is whether the assessee had incurred any expenditure in respect of which it has claimed income to be exempt under the Act. If yes, what was the expenditure which was incurred and claimed by the assessee as deduction under the Act?

7. The Assessing Officer disallowed ₹ 1.50 crores as expenses apportioned for exempt income under Section 14A of the Act. The finding recorded reads thus:-

> “7.Expenditure incurred in relation to income not includible in total income.
>
> A very huge portion of the assessee's capital is invested in strategic investments in subsidiary companies, joint ventures and other investments. These investments are in the form of securities, therefore the objective of the company in holding them is to earn dividends.
>
> Total funds of ₹ 361.64 crore out of total capital and funds of ₹ 654 crore i.e. more than 55% of company's funds is lying invested in such investments. The dividend income on some of these investments amounting to ₹ 2,11,14,273/- is exempt under section 10(33) of the IT Act and has been

excluded correctly by the assessee from its total income. However, the assessee has failed to allocate any expenditure as being related to this income and has not offered anything as disallowable expenditure under the provisions of section 14A. It is to be mentioned that under this section, no deduction is allowable in respect of expenditure incurred by the assessee in relation to income which does not form part of total income under the Act.

In this scenario where the company had invested huge amounts in such investments and had claimed a loss of ₹ 14.82 crores on account of its corporate office, the assessee was called upon to allocate its expenses towards its investment activities and monitoring of these investments. Besides these expenses, large part of expenditure and energies of the treasury division of the company are also devoted towards these investments.

The assessee replied to it vide letter dated 29.3.2004 and its submissions regarding this can be summarized as under-

i) The direct expenses of one particular investment, related to atleast, in the form of foreign travelling has not been claimed by the assessee as revenue expenditure. The assessee was not able to divide its expenses into those relatable to its running of businesses and those relatable to protecting and planning its investments.

ii) The total expense on salaries of directors and travelling is only around ₹ 80 lacs. The directors are not devoting much time to the investment activities.

iii) The assessee claimed that only the expenses incurred for earning the income i.e. specific to the securities on which dividend has been received, is disallowable.

iv) The assessee's contentions have been gone through and are rejected in view of the following-

a) Section 14A talks about expenditure incurred by assessee in relation to income which has much larger scope than the limited scope of expenditure incurred for earning an income. Therefore, all expenses in relation to the earning of dividend income would have to be allocated and disallowed.

b) Expenditure incurred in relation to investments which were there for earning dividend income but during the year did not yield any dividend, is also not allowable. For example, a person engaged in agriculture activities cannot claim the expenses from other income even if the entire crop fails.

c) As discussed above, there are corporate expenses of ₹ 14.82 crore. A large part of it has definitely gone towards holding and monitoring the investments which have yielded/were meant for earning dividend. The investments made in securities meant for earning dividend are more than 55% of total capital and funds i.e. ₹ 361.64 crores out of ₹ 654 crores. The investments are even simple securities of other companies but include lot of strategic investments in the form of subsidiaries companies and joint ventures. In these investments, there ought to be much energies spent, lot of planning involved and expenses incurred for such investments.

d) Substantial time of its executives, expenses like conveyance, travelling, expenses on meetings, telephone and huge incidental expenses ought to be there on this account. As these expenses are definitely relatable to earning of an exempt income, therefore, these ought to be apportioned as in the case of Distributors (Baroda) Pvt. Limited vs. Union of India, (1985) 155 ITR 120(SC).

Looking to the extent of investments of the assessee and the expenses in the corporate office, an amount of ₹ 1.50 crore is apportioned as being in relation to such exempt income and is disallowed under Section 14A of the IT Act, 1961."

8. The CIT(A) while allowing partial relief to the assessee recorded as under:-

"I have considered the rival positions and analysed the averments of the appellant. Having done so, I am unable to acquiesce in the contentions of the appellant. It must be emphasized that the language of section 14A is very broad in its scope. The section does not specify that the expenditure incurred by an assessee for earning income which is excluded from the total income is to be disallowed. The section provides that expenditure incurred in relation to income which does not form part of the total income will not be allowed. A judgment of the Hon'ble Supreme Court in the case of Distributors (Baroda) Private Limited vs. Union of India 155 ITR 120 throws light on this issue. The Hon'ble Supreme court had held that in order to compute income from dividend, interest on moneys borrowed for earning such income is to be deducted. In view of the above, I hold that provisions of Section 14A are applicable on the facts of the present case.

But having held that a disallowance under Section 14A is called for, I feel that the AO has clearly erred in making a whopping adhoc disallowance for ₹ 1.50 crores. The AO has not discharged the onus of proving what amount had been incurred for earning the dividend income before making the disallowance. Further, to link the disallowance with the amount of investment is also not rational since making investment is not a regular activity and involves continuous monitoring. Moreover, the appellant has itself disallowed the direct expenditure incurred on investment activities. Further, since the appellant has been running a number of operating divisions like pharmaceutical, BOPP, Maxfoil, Metaliser and Healthcare, considerable time of the corporate office employees could be expected to be spent on these activities rather than investment activities. Taking the totality of the circumstances into consideration, I hold that the disallowance of ₹ 1.50 crore made by the Assessing Officer is excessive looking at the diversified nature of the activities carried on by the appellant. I accordingly consider it just and fair to restrict the disallowance under Section 14A to ₹ 10 lacs. Therefore while an addition of ₹ 1.4 crores is deleted, the disallowance of ₹ 10 lacs is confirmed."

9. The Tribunal after examining the matter held that no disallowance under section 14A could be made without establishing proximate nexus on a reasonable basis between the expenditure incurred and the exempt income earned. The relevant findings recorded by the Tribunal read thus:-

"**a. Interest expenditure**

Investments as on 1.4.2000 (₹ 263.13 crores)

A.I. Investments vesting on merger of MCL – ₹ 195.48 crores. As the beginning of the previous year relevant to assessment year 2000-01 (i.e. as on 1.4.2000), being the first year of disallowance under section 14A, the assessee held total investment in shares/mutual funds/government securities/bonds, aggregating to ₹ 263.13 crores. Out of the aforesaid total investments, investments to the extent of ₹ 195.48 crores, vested in the assessee on merger of MCL (PB-99 of supplementary PB).

It would be pertinent to point out that the erstwhile MCL had not made investment in shares, out of borrowed funds in as much as the MCL did not had any interest bearing borrowed funds, nor any interest expenditure was debited in the profit and loss account of that company, prior to merger with the assessee (PB-97 and 102 of supplementary PB).

Therefore, the investments to the extent of ₹ 195.48 crores, held by the assessee as on 1.4.2000 had no nexus with the borrowed funds.

A.2 Balance investments ₹ 6765 crores.

A.2.1 Investments, not resulting in earning of exempt income – ₹ 36.01 crores.

As regards the balance investments, amounting to ₹ 67.65 crores (₹ 263.13 crore – ₹ 195.48 crores) held as on 1.4.2000 the same included investment in shares of foreign subsidiary company and other Government securities/Bonds/mutual funds, the income wherefrom was not exempt from tax under the provisions of the Act, aggregated to ₹ 36.01 crores. The break up of the aforesaid investments is as under (PB87-88 of supplementary PB):

Nature of investment	***Amount in Rs. And crores***
Foreign subsidiaries	
Max Asia Pac Limited	11.33
Max UK Limited	2.13
Max Visions Inc.	0.95
BONDS	
Reliance Zero Coupon Bonds	6.1
HDFC Bonds	0.62
MTNL Limited	0.57
Reliance Petroleum	3.31
Units in Growth Scheme	
Kothari Pioneer Maxima Fund	10
DSP MerryL Lynch Balance Fund Growth	1
Total	36.01

In view thereof, the interest expenditure incurred on borrowed funds, if any attributable to the aforesaid investments, income wherefrom is not exempt under the provisions of the Act is ousted from the application of the provisions of section 14A of the Act.

A.2.2 Remaining investments, out of interest free funds ₹ 31.64 crores.

The break up of balance investments, aggregating to ₹ 31.64 crores is as under PB 87-88:

Nature of investment	***Amount in ₹ in crores***
Max Telecom Ventures Limited	30
(MTVL)	
Alliance Capital Mutual fund and others	1.64
Total	31.64

Out of the aforesaid investments, aggregating to ₹ 31.64 crores, it would be appreciated that, major investment related to investment in shares of MTVL amounting to ₹ 30 crores. The said total investment in shares of MTVL, it is submitted was made in the previous year ending 31.3.1996. On perusal of the cash flow statement of the assessee company for the year ending 31.3.1996 attached as Annexure A to this Chart, it would be noted that the assessee had made a fresh issue of share capital at a premium, aggregating to ₹41.55 crores (₹ 1.42+40.13 crores). Further, the assessee received funds of ₹ 22.65 crores from issue of zero coupon fully convertible debentures (FCD) which did not carry any interest. In addition to above, the assessee generated cash from operations of ₹ 6.34 crores. The aforesaid total interest free receipts, it would be appreciated, were sufficient to make investment in shares of MTVL.

That apart, in that year, the assessee had made additional interest bearing borrowing of ₹ 40.33 crores (Refer Schedule 3 of balance sheet for year ending 31.3.1996) on account of secured redeemable non convertible debentures (NCD).

It would be pertinent to point out that the aforesaid NCD of ₹ 40.33 crores (carrying interest) and Zero Coupon FCD (interest free) of ₹ 22.65 crores were issued through a same letter of offer, which was placed on record before learned CIT(A) vide submission dated September 18, 2009 (PB 251).

The object of aforesaid proceeds, as per the letter of offer, was to meet out the capital expenditure of the existing divisions, working capital requirements, repayment of term loans and investment in joint ventures.

However Note 3 of the offer document (PB-251) stipulated that proceeds of NCD (interest bearing) were not utilized for investment in shares of group companies of joint ventures. The aforesaid object was to be met out of the proceeds of zero coupon FCDs. The relevant portion of the aforesaid note reads as under:-

> "As per the SEBI guidelines for disclosure and investor protection – clarification II, the proceeds of NCD issue cannot be utilized for acquisition of shares and/or providing loan to any company belonging to the same group.

"In line, with above, company's requirements for investments into joint ventures in Phase I, is proposed to be met through the proceeds of FCD issue and/or preferential issue of warrants to the management group."

In view of the above, no portion of the interest bearing NCD was utilized towards investment in shares of MTVL, a group company of the assessee.

Further, as is evident from the case flow statement of the year ending 31.3.1996, against the aforesaid aggregate interest bearing borrowing of ₹ 40.33 crores (from NCD), the assessee had acquired fixed assets from an amount of ₹

35.20 crores and repaid existing loans of ₹ 6.38 crores.

In that view of the matter, the investment in shares of MTVL was made of interest free funds and no portion of the interest bearing borrowed funds were utilized for making that investment, which were utilized for other business purposes of the assessee and therefore, no portion of interest expenditure in any year including the assessment year 2000-01 and onwards, had no nexus with said investment, warranting disallowance under section 14A of the Act."

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48. We have heard the rival contentions and perused the facts of the case. The disallowance was made by the AO on adhoc basis, proceeding on the assumption that some expenditure must have been incurred by the assessee towards earning exempt dividend income. The order of the learned CIT(A) also proceeds on the same basis, as the learned CIT(A) too has reduced the disallowance on adhoc basis. We are of the view that no disallowance under section 14A can be made without establishing proximate nexus on a reasonable basis between the expenditure incurred and the exempt income earned. This position is now well settled by catena of decisions. We also find that cash flow statement was part of the audited accounts filed before the lower authorities and the assessee has before us only submitted a data analysis with reference to the figures available in the audited accounts to support its claim that no part of interest expenditure could be attributed to earning of except income and therefore, no disallowance under section 14A of the Act was called for. On perusal of cash flow statement, it is evident that the assessee had sufficient surplus funds available with it for making investments. Having regard to the various decisions cited by the learned AR in the case of mixed pool of funds, if the

> surplus funds available with the assessee on an overall basis during the financial year are sufficient to make investment, presumption needs to be drawn that surplus funds and not interest bearing funds could be said to have been used for making investments by the assessee in the financial instruments yielding exempt income. Hence, no part of interest expenditure can be considered for the purpose of computing disallowance under Section 14A of the Act. Further, in the absence of any proximate nexus having been established by the lower authorities between the administrative and other expenses and the exempt income, in our view, no disallowance under section 14A of the Act could have been made for the assessment year under consideration."

10. A perusal of the findings recorded above shows that in the opinion of the Assessing Officer, under Section 14A of the Act, no deduction was allowable in respect of expenditure incurred by the assessee in relation to the income which did not form part of total income under the Act. Further the expenditure incurred in relation to investments which were for earning dividend Income but during the year did not yield any dividend, was not allowable. The expenses like conveyance, travelling, telephone and other incidental expenses were relatable to earning of exempt income. Therefore, an amount of ₹ 1.50 crore was apportioned as being in relation to such exempt income and was disallowed under Section 14A of the Act. On appeal by the assessee, the CIT(A) did not agree with the findings recorded by the Assessing Officer. It was observed by the CIT(A) that since the assessee had been running a number of operating divisions like

pharmaceutical, BOPP, Maxfoil, Metaliser and Healthcare, considerable time of the corporate office employees could be expected to be spent on these activities rather than investment activities. Keeping in view the nature of activities carried on by the assessee, the CIT(A) restricted the disallowance to ₹ 10 lacs only. The Tribunal after considering the matter held that no part of interest expenditure could be considered for the purpose of computing disallowance under Section 14A of the Act. Further, in the absence of any proximate nexus having been established by the lower authorities between the administrative and other expenses and the exempt income, no disallowance under section 14A of the Act could have been made for the assessment year under consideration. Learned counsel for the appellant-revenue has not been able to show any illegality or perversity in the approach of the Tribunal or that the findings recorded by it are erroneous.

11. In ***Hero Cycles Limited's*** case (supra), while dealing with identical situation, it was observed by this court that whenever any disallowance under Section 14A of the Act is to be made, then it has to be established that incurring of expenditure had direct nexus with the earning of the exempted income. It was held as under:-

> "4. In view of finding reproduced above, it is clear that the expenditure on interest was set off against the income from interest and the investment in the share and funds were out of the dividend proceeds. In view of this finding of fact, disallowance under Section 14A was not sustainable. Whether, in a given situation, any expenditure was incurred which was to be disallowed, is a question of fact. The contention of the

> revenue that directly or indirectly some expenditure is always incurred which must be disallowed under Section 14A and the impact of expenditure so incurred cannot be allowed to be set off against the business income which may nullify the mandate of Section 14A, cannot be accepted. Disallowance under Section 14A requires finding of incurring of expenditure where it is found that for earning exempted income no expenditure has been incurred, disallowance under Section 14A cannot stand...."

12. Similar view was expressed by this Court in ***Metalman Auto P. Limited's*** case (supra). It was concluded by this Court that disallowance under Section 14A of the Act requires a finding of incurrence of expenditure for earning the exempt income. In case, no expenditure has been incurred, the disallowance under Section 14A is not justified. In other words, there cannot be presumption that certain expenditure is bound to be incurred for earning the exempt income.

13. Adverting to the judgment relied upon by the learned counsel for the appellant-revenue, it may be noticed that in ***Walfort Share and Stock Brokers P. Limited's*** case (supra), the Tribunal held that the assessee was entitled to set off loss from transactions against its other Income chargeable to tax. The said view was affirmed by the High Court. The question before the Apex Court was whether loss arising in the course of dividend stripping transaction taking place prior to 1.4.2002 was disallowable on the ground that such loss was artificial as the dividend stripping transaction was not a business transaction. After examining the legal and factual position therein, it was held that in cases arising before

1.4.2002, losses pertaining to exempted income could not be disallowed. Such is not the position in the present case.

14. In view of the above, the substantial question of law is answered against the revenue. The appeal stands dismissed.

(Ajay Kumar Mittal)
Judge

October 1, 2015 **(Ramendra Jain)**
'gs' **Judge**