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\* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

**Decided on: 06.12.2016**

+ **ITA 781/2016**

**PRINCIPAL COMMISSIONER OF INCOME-TAX (CENTRAL) - I**  
..... Appellant

Through : Sh. Dileep Shivpuri, Sr. Standing  
Counsel, Sh. Sanjay Kumar, Jr. Standing Counsel  
and Sh. Vikrant A. Maheshwari, Advocate.

Versus

**M/S. U. K. PAINTS (INDIA) PVT. LTD.** ..... Respondent

Through : Sh. Tarun Singh, Advocate.

**CORAM:**  
**HON'BLE MR. JUSTICE S. RAVINDRA BHAT**  
**HON'BLE MR. JUSTICE NAJMI WAZIRI**

**MR. JUSTICE S. RAVINDRA BHAT (OPEN COURT)**

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1. The Revenue claims to be aggrieved against an order of the Income Tax Appellate Tribunal (ITAT) in this appeal under Section 260A of the Income Tax Act, 1961 [hereafter "the Act"].
2. The question of law urged is with respect to the cancellation of disallowance made under Section 14A of the Act read with Rule 8D of the Income Tax Rules.
3. During the relevant Assessment Year (AY) 2006-07, the assessee's

return had reported tax exempt income to the tune of over ₹25 crores. The Assessing Officer (AO) framed the assessment after applying disallowance under Section 14A of the Act in respect of this tax exempt income – during the course of which he did not accept the proffered disallowance of ₹7.5 lakhs made by the assessee. The relevant discussion by the AO is reproduced as follows:

***“1. Deemed Dividend:-***

*During Assessment proceedings, an intimation from ACIT Circle 3(1) and Addl. CIT, Range-3, have been received regarding applicability of section 2(22)(e) in the hands of the assessee. The facts of the intimation received from ACIT, Circle 3(1) and also Addl. CIT, R-3 are that assessee company is having substantial interest holding 61% of shares in MIS Citiland Commercial Credits Ltd. and also having accumulated profits as on 31.03.2006 of Rs. 8.47 Crores. As per the intimation the assessee company has received a loan of Rs. 12,25,055/- from MIS Citiland Commercial Credits Ltd. during the F.Y. 2005-06 relevant to the A.Y. 2006-07. On receipt of intimation from the ACIT Circle 3(I), assessee was asked to show a cause as to why loan taken of Rs. 12.25,055/- from MIS Citiland commercial Credits Ltd. should not be treated as deemed dividend. In response, assessee company has filed an explanation vide letter dated 12.12.2008. the relevant contents are reproduced as under:-*

*"1. Details of loans and advances received during the year as interest free from M/s Citiland Commercial and M/s. Bigg Investment. Both the companies main business is investment and finance and they are registered with Reserve Bank of India as NBFC. Their main source of income is from Investment and Finance (Dividend), so section 2(22)(e) is not applicable on advances given by them to U K Paints. "*

*I have considered assessee's submission. If M/s. Citiland Commercial Credits and M/s. Bigg Investment are in lending*

*business, then why interest was not charged on the advances given to the assessee company, this itself goes against the assessee's contention of the company under consideration is in investment and finance. As all the conditions mentioned in section 2(22)(e) are met, I hold that it is a clear case of deemed dividend and therefore, an amount of Rs. 12,25,055/- is added in the hands of the assessee and taxed.*

*In the case of M/s. Bigg Investment similar conditions are existed in the case of M/s. Citiland Commercial Credits Ltd are existed. Therefore, I hold that it is a deemed dividend case and therefore an addition of Rs. 7,40,988/- is made in the hands of the assessee and taxed accordingly.*

*(Addition: Rs. 12,25,055/-)*

## **2. Disallowance u/s 14A:-**

*During the year, assessee has shown turnover of Rs. 15,86,01,692.73. On further scrutiny of the record, it is found that sales income at as net Rs. 52,82,6042/- and goods processing charges sum of Rs. 10,57,57,650/-. The above facts reveals that assessee is doing manufacturing activity to other than self.*

*In addition to the above, assessee has credited other income of Rs. 32,15,11,5591- in which following items are exempt income.*

|                                     |          |                               |
|-------------------------------------|----------|-------------------------------|
| <i>Dividend</i>                     | <i>:</i> | <i>Rs.21,89,60,291</i>        |
| <i>LTCG u/s 10(38)</i>              | <i>:</i> | <i>Rs.2,55,94,312</i>         |
| <i>LTCG on sale of Mutual Funds</i> | <i>:</i> | <i><u>Rs.90,20,240</u></i>    |
|                                     |          | <i><u>Rs.25,35,74,843</u></i> |

*On perusal of expenses shown in schedule 13, it is noticed that there is an increase to the tune of Rs. 2,55,02,142/- over the last year's expenses. During the year an amount of Rs.12,21,92,786.19 is claimed whereas last year i.e. A.Y. 2005-*

06, an amount of Rs. 9,66,90,644/- was claimed. The turnover of A.Y. 2005-06 was shown at Rs. 16,04,18,581/- and other income was at Rs. 3523931831/-, the total amount of income shown at Rs. 47,75,96,683/-. The increase is seen in other income when compared to last year. This increase stood at Rs. 12,09,87,586/-. On the other hand, expenses have also increased to the tune of Rs. 2,55,02,142/-, when compared with immediate preceding year i.e. A.Y. 2005-06.

The above discussion reveals that there is a direct nexus between the increase in exempt income and increase in the expenses. Therefore, I hold that an amount of Rs. 2,55,02,142/- under the head expenses are attributable to the increased exempted income. Therefore, this amount is disallowed u/s 14A. Since exempted income is not taxable and expenses attributable to this income has to be disallowed. Thus lump sum disallowance is made on the basis of above discussion to the tune of Rs. 2,55,02,142/- and added back to the assessee's income.

(Addition: **Rs. 2,55,02,142/-**)”

4. The order of the AO was rectified under Section 154 of the Act but without yielding any relief; the AO merely clarified that the amount of ₹7.5 lakhs offered was not “taken into consideration” at the time of passing the order under Section 143(3). The AO, therefore, reduced that amount from the figure of the determined disallowance. The appellate Commissioner [hereafter “CIT”], on being approached, was of the opinion that the rejection of ₹7.5 lakhs was valid and restored the matter for fresh computation to the AO. The relevant part of the CIT’s observations are as follows:

“4.4 In the proceedings before me, appellant was again asked to explain the basis for computing the disallowance u/s 14A at Rs. 7,50,000/-. It has been argued for the appellant that earning of dividend income and tax free interest income did not require

*any extra efforts or substantial expenses, other than the efforts/supervision of the banking section. That it had accordingly debited part of the salary of Director Shri K.S. Dhingra (who was looking after the banking section, among other work) apart from debiting the full salary of the banking officials Shri K.S. Nair and Shri Tejinder Singh. That other expenses such as telephone, petrol, printing & stationery had also been debited on estimate basis.*

*4.5 I have considered the reasons for disallowance, the method of computation adopted by the Assessing Officer and the various submissions made by the appellant in this regard. I have also gone through the order of the ITAT in appellant's own case, vide ITA Nos.2686/Del/2005&2006/Del/2006 for A. Yrs. 2001-02, 2002-03 & 2003-04. Vide para 10 the ITAT has observed as under:*

*"We have considered the rival contentions. In view of the decision of special bench, there is no iota of doubt to the effect that intention behind using the expression "in relation to" in section 14A is to encompass not only the direct but also the indirect expenditure which has any relation to the exempt income. Accordingly, there is no merit in the order of the CIT(A), we therefore uphold the order of the AO for disallowance of Rs. 10 lakhs. In the result, this ground is allowed in favour of the Revenue."*

*Thus, in view of the above, both the direct and indirect expenditure which have any relation to exempt income are disallowable u/s. 14A. The fact of disallowability of expenditure in relation to the exempt income has also been admitted by the appellant and it has, suo-moto, disallowed a sum of Rs. 7,50,000/-. However, the AO in present year, as well as the Hon'ble ITAT in preceding years as is evident by way of their confirmation of the addition made by the AO are not satisfied about the correctness of the claim of Appellant. But it appears that the appellant as well as the AO have erred in their method of computation.*



*4.6 Rule 8D was inserted in IT Rules w.e.f. 24.03.2008 for the purpose of determining the amount of expenditure in relation to income not includable in total income, as envisaged in 14A. The AO ought to have adopted the method of calculation as prescribed in Rule 8D, rather than making his own estimates, since he passed the order on 30.12.2008. when Rule 8D was very much in existence. It may not be out of place to mention here that insertion of Rule 8D bring procedural in nature, takes the retrospective effect and the assessment which are pending at any stage before the AO, CIT(A) or Tribunal of High Courts would be governed by the mandate of Rule 8D as sub-section (2) & (3) of section 14A of the IT Act r.w.r. 8D procedural in nature and hence retrospective. In this regard reference is made to ITO Vs. Daga Capital Management P. Ltd. (2008) TTJ (Mumbai) (SB) 289; ITO Vs. Sagar Capital management (P) Ltd. (2008) 119 TTJ (Mumbai) SB; Aquarius Travel (P) Ltd. Vs. ITO (2008) 114 TTJ (Del) SB 584). **Therefore, the AO is directed to compute the disallowance of expenditure relatable to the exempt income in accordance with Rule 8D.**”*

5. In the impugned order, the ITAT relied upon the decision of this Court in *CIT-VI v. Taikisha Engineering India Ltd.* 2015 (370) ITR 338 (Delhi) to the effect that the AO can proceed to make an independent determination of the disallowance under Rule 8D read with Section 14(2) *after* recording his satisfaction about the amount and the reasons thereof proffered by the assessee voluntarily under Section 14A. The relevant observations of this Court are as follows:

*“18. It is in this context we feel that the findings recorded by the CIT(A) and the Tribunal are appropriate and relevant. The clear findings are that the assessee had sufficient funds for making investments in shares and mutual funds. The said findings coupled with the failure of the Assessing Officer to hold and record his satisfaction clinches the issue in favour of the*

*respondent assessee and against the Revenue. The self or voluntary deductions made by the assessee were not rejected and held to be unsatisfactory, on examination of accounts. Judgments in Tin Box Co. (supra), Reliance Utilities and Power Ltd. (supra), Suzlon Energy Ltd. (supra) and East India Pharmaceutical Works Ltd. (supra) would be relevant if the satisfaction of the Assessing Officer is in issue, and such question of satisfaction is with reference to the accounts.*

*19. However, the decisions relied upon by the Tribunal in the case of Tin Box Co. (supra), Reliance Utilities and Power Ltd. (supra), Suzlon Energy Ltd. (supra) and East India Pharmaceutical Works Ltd. (supra) could not be now applicable, if we apply and compute the disallowance under Rule 8D of the Rules. The said Rule in sub Rule (2) specifically prescribes the mode and method for computing the disallowance under Section 14A of the Act. Thus, the interpretation of clause (ii) to sub Rule (2) to Rule 8D of the Rules by the CIT(A) and the Tribunal is not sustainable. The said clause expressly states that where the assessee has incurred expenditure by way of interest in the previous year and the interest paid is not directly attributable to any particular income or receipt then the formula prescribed would apply. Under clause (ii) to Rule 8D(2) of the Rules, the Assessing Officer is required to examine whether the assessee has incurred expenditure by way of interest in the previous year and secondly whether the interest paid was directly attributable to particular income or receipt. In case the interest paid was directly attributable to any particular income or receipt, then the interest on loan amount to this extent or in entirety as the case may be, has to be excluded for making computation as per the formula prescribed. Pertinently, the amount to be disallowed as expenditure relatable to exempt income, under sub Rule (2) is the aggregate of the amount under clause (i), clause (ii) and clause (iii). Clause (i) relates to direct expenditure relating to income forming part of the total income and under clause (iii) an amount equal to 0.5% of the average amount of value of investment, appearing in the balance sheet*

*on the first day and the last day of the assessee has to be disallowed.*

*20. However, in the present case we need not refer to sub Rule (2) to Rule 8D of the Rules as conditions mentioned in sub Section (2) to Section 14A of the Act read with sub Rule (1) to Rule 8D of the Rules were not satisfied and the Assessing Officer erred in invoking sub Rule (2), without elucidating and explaining why the voluntary disallowance made by the assessee was unreasonable and unsatisfactory. We do not find any such satisfaction recorded in the present case by the Assessing Officer, before he invoked sub Rule (2) to Rule 8D of the Rules and made the re-computation. Therefore, the respondent assessee would succeed and the appeal should be dismissed.”*

6. It is urged on behalf of the revenue by Sh. Dileep Shivpuri, Sr. Standing Counsel that the AO's order clearly contemplates his application of mind which is reflected in the computation and that if there was any formal inadequacy in the expression of satisfaction, that was secured in the appellate orders of the Commissioner who clearly rejected the explanation given by the assessee.

7. Learned counsel for the assessee, on the other hand, urges that the ruling in *Taikisha (supra)* is categorical in that it is the AO's satisfaction, or in other words, the AO's reasons for rejection of the amounts offered which is crucial, and not a satisfaction made by an appellate authority. It is submitted that in this case, significantly even though the AO did not take into account the amount offered, it is evident from the facts that in the rectification order, he acknowledged that ₹7.5 lakhs had been offered as voluntary disallowance. Therefore, the question of rejection of that amount or seeking explanation did not arise. In fact, there was no opinion by the AO.



8. Section 14A reads as follows:

***“Expenditure incurred in relation to income not includible in total income.***

***14A. (1) For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.***

***(2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed<sup>19</sup>, if the Assessing Officer, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to income which does not form part of the total income under this Act.***

***(3) The provisions of sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act :***

***Provided that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001.”***

9. The above provision is in a sense a taxing exception to the stream of income which is otherwise exempt, i.e. tax exempt income. The principle of disallowance is stated in Section 14A(1). Section 14A(2) prescribes the mode or methodology for the disallowance and the steps for its calculation. Unlike the other part of the statute which decree or enjoin the actual methodology and are substantive, Parliament deemed it appropriate to leave it to the rule making authority to prescribe the methodology, i.e.

computation. For instance, what are taxable and in what proportion and the principles applicable are embedded in the statute in certain provisions, such as Sections 28 to 43 and Sections 80A to 80HHC when it comes to deductions. Instead of adopting that mode, the Parliament thought it appropriate to leave the mode to the rule making authority. In that sense, the rules are not merely procedural but are substantive and can be said to be engrafted in the statute, as is evident from the mandate of the first part of Section 14A(2). That apart, significantly, the question of applying the statutorily prescribed method would arise only and only if the AO expresses an opinion rejecting the assessee's methodology and the figure offered at the time of assessment. This is material because the jurisdiction to go into the method prescribed in the Rules arise only if the amounts the assessee offers does not have any realistic correlation with the tax exempt income. For instance, in a given case, if a tax exempt income is to the tune of ₹5 crores and the assessee is able to satisfy that expenditure relatable to that income or the reasonable nexus to such income is ₹25 lakhs, there has to be strong reasons why the said amount of ₹25 lakhs are to be rejected. In other words, the opinion of the assessing officer in the latter part [of Section 14A(2)] is to be based upon an appraisal of objective material relating to the assessee's voluntary disallowance of amount/amounts. Not only that, if in the course of assessment, the AO enquires from the assessee about the amounts spent, which are to be disallowed, and the assessee in fact discloses a larger amount (than the one given in the return), it is still incumbent upon the AO to enquire into such larger amounts and determine whether it has nexus with expenditure relatable to exempt income to attract Section 14A(1). *Sans* this procedure, Section 14A would be reduced to a mere formality which it

appears to have become in the circumstances of the case. Consequently, we are of the opinion that there is no infirmity in the reasoning and conclusions of the ITAT. The appeal is accordingly dismissed.

**S. RAVINDRA BHAT**  
**(JUDGE)**

**NAJMI WAZIRI**  
**(JUDGE)**

**DECEMBER 6, 2016**

