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

+ ITA No. 1253/2018

HERO MOTOCORP LTD.

..... Appellant

Through: Mr.Ajay Vohra, Mr.Aniket D.
Agrawal and Ms.Deepika Agrawal,
Advs.

versus

DEPUTY COMMISSIONER OF INCOME TAX..... Respondent

Through: Mr.Ruchir Bhatia, Adv.

CORAM:

HON'BLE MR. JUSTICE SANJIV KHANNA

HON'BLE MR. JUSTICE ANUP JAIRAM BHAMBHANI

ORDER

% **11.01.2019**

Learned senior counsel for the appellant submits that finding of the Income Tax Appellate Tribunal with regard to recording of satisfaction under sub-section 2 of Section 14A is wrong as the Assessing Officer by the said sub-section has to record specific finding having regard to accounts of the assessee which is missing in this case.

We do not think that this contention is correct. In fact, the order passed by the Assessing Officer would show application of mind in all senses of the phrase. We would reproduce the findings recorded by the Assessing Officer for the assessment year 2012-13 which read as under:-

19. Disallowance u/s 14A; Rs. 66,35,000/-;

“19.1 In the course of assessment proceedings assessee was required to show cause why disallowance u/s 14A read with Rule 8D should not be made and added to its taxable income.

19.2 Assessee's submission:

During the relevant previous year, the assessee company earned dividend/interest income of Rs. 11.54 crores from investments in shares, bonds, and mutual funds, which was exempt under section 10(34)/10(35)/10(15)(iv)(h) of the Act. In view of the provisions of section 14A of the Act, the assessee computed expenses disallowable under that section at Rs. 65.23 lacs, in the return of income filed for the relevant assessment year.

While computing the amount of disallowance of Rs. 65.23 lacs under section 14A of the Act in the return of income, the assessee considered salary paid to employees, who were involved in treasury function, as follows:

Proportional Employee's Cost						
EC No.	Name	Designation	Time devoted	Salary cost (in Rs)	%age	Total (Rs.)
1811	Vineet Luthra	Asstt. Manager	Partly	10,24,242	100%	10,24,242
4023	Ashish Mishra	DGM	Partly	34,49,081	100%	34,49,081
				44,73,323		44,73,323

Further entire Portfolio management fees Rs. 20,49,692/- were also disallowed.

In the notice, the assessee has been asked to show cause as to why the disallowance under Section 14A be not computed as per provisions of Rule 8D of the Rules.

Reliance, in this regard, is placed on the recent decision of Delhi High Court in the case of Maxopp Investment Ltd. vs. CIT 247 CTR 162, wherein after considering the aforesaid decision of Supreme Court, the High Court has analyzed the scope of provisions of section 14A and the powers vested with the assessing officer before invoking the same. The High Court held, that the expression "expenditure incurred" refers to actual expenditure and not to some imagined expenditure. It was held, that the provisions of sub-section (2)/(3) of section 14A read with Rule 8D of the Rules can be applied from assessment year 2008-09 and onwards, only if the assessing officer first rejects the claim of the assessee of having not incurred any expenditure in relation to earning of exempt income, with cogent reasons. In other words, the onus is on the assessing officer to establish nexus of expenses with exempt income, before rejecting the claim of assessee and computing disallowance under section 14A as per Rule 8D of the Rules. The relevant observations of the High Court are as under:

“.....

Thus, we will have to consider the argument of the assesseees in respect of the expression "expenditure incurred" in the context of the expenditure being in connection with or pertaining to income which does not form part of the total income under the said Act.

27. A reference was made to the decision of the Punjab and Haryana High Court in the case of CIT-II v. Hero Cycles Ltd [ITA No. 331/2009; decided on 4/11/2009] wherein it was observed that:-

"Disallowance under Section 14A requires finding of incurring expenditure where it is found that for earning exempted income no expenditure has been incurred, disallowance under Section 14A cannot stand."

28. It was contended that unless and until there was actual expenditure for earning the exempted income, there could not be any disallowance under section 14A. While we agree that the expression "expenditure incurred" refers to 'actual' expenditure and not to some imagined expenditure we would like to make it clear that the 'actual' expenditure that is in contemplation under section 14A(1) of the said Act is the 'actual' expenditure in relation to or in connection with or pertaining to exempt income. The corollary to this is that if no expenditure is incurred in relation to the exempt income, no disallowance can be made under section 14A of the said Act.

Scope of sub-sections (2) and (3) of Section 14A

29. Sub-section (2) of Section 14A of the said Act provides the manner in which the Assessing Officer is to determine the amount of expenditure incurred in relation to income which does not form part of the total income. However, if we examine the provision carefully, we would find that the Assessing Officer is required to determine the amount of such expenditure only 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 the said Act. In other words, the requirement of the Assessing Officer embarking upon a determination of the amount of expenditure incurred in relation to exempt income would be triggered only if the Assessing Officer returns a finding that he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. Therefore, the condition precedent for the Assessing Officer entering upon a determination of the amount of the expenditure incurred in relation to exempt income is that the

Assessing Officer must record that he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. Sub-section (3) is nothing but an offshoot of sub-section (2) of Section 14A. Sub-section (3) applies to cases where the assessee claims that no expenditure has been incurred in relation to income which does not form part of the total income under the said Act. In other words, sub-section (2) deals with cases where the assessee specifies a positive amount of expenditure in relation to income which does not form part of the total income under the said Act and sub-section (3) applies to cases where the assessee asserts that no expenditure had been incurred in relation to exempt income. In both cases, the Assessing Officer, if satisfied with the correctness of the claim of the assessee in respect of such expenditure or no expenditure, as the case may be, cannot embark upon a determination of the amount of expenditure in accordance with any prescribed method, as mentioned in sub-section (2) of Section 14A of the said Act. It is only if the Assessing Officer is not satisfied with the correctness of the claim of the assessee, in both cases, that the Assessing Officer gets jurisdiction to determine the amount of expenditure incurred in relation to such income which does not form part of the total income under the said Act in accordance with the prescribed method. The prescribed method being the method stipulated in Rule 8D of the said Rules. While rejecting the claim of the assessee with regard to the expenditure or no expenditure, as the case may be, in relation to exempt income, the Assessing Officer would have to indicate cogent reasons for the same.

Rule 8D

30. As we have already noticed, sub-section (2) of Section 14A of the said Act refers to the method of determination of the amount of expenditure incurred in relation to exempt income. The expression used is - "such method as may be prescribed". We have already mentioned above that by virtue of Notification No.45/2008 dated 24/03/2008, the Central Board of Direct Taxes introduced Rule 8D in the said Rules. The said Rule 8D also makes it clear that where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with (a) the correctness of the claim of expenditure made by the assessee; or (b) the claim made by the assessee that no expenditure has been incurred in relation to income which does not form part of the total income under the said Act for such previous year, the Assessing Officer shall determine the amount of the expenditure in relation to such income in accordance

with the provisions of sub-rule (2) of Rule 8D. We may observe that Rule 8D(1) places the provisions of Section 14A(2) and (3) in the correct perspective. As we have already seen, while discussing the provisions of Sub-sections (2) and (3) of Section 14A, the condition precedent for the Assessing Officer to himself determine the amount of expenditure is that he must record his dissatisfaction with the correctness of the claim of expenditure made by the assessee or with the correctness of the claim made by the assessee that no expenditure has been incurred. It is only when this condition precedent is satisfied that the Assessing Officer is required to determine the amount of expenditure in relation to income not includable in total income in the manner indicated in sub-rule (2) of Rule 8D of the said Rules.

31. It is, therefore, clear that determination of the amount of expenditure in relation to exempt income under Rule 8D would only come into play when the Assessing Officer rejects the claim of the assessee in this regard. If one examines sub-rule (2) of Rule 8D, we find that the method for determining the expenditure in relation to exempt income has three components. The first component being the amount of expenditure directly relating to income which does not form part of the total income. The second component being computed on the basis of the formula given therein in a case where the assessee incurs expenditure by way of interest which is not directly attributable to any particular income or receipt. The formula essentially apportions the amount of expenditure by way of interest [other than the amount of interest included in clause (i)] incurred during the previous year in the ratio of the average value of investment, income from which does not or shall not form part of the total income, to the average of the total assets of the assessee. The third component is an artificial figure – one half percent of the average value of the investment, income from which does not or shall not form part of the total income, as appearing in the balance sheets of the assessee, on the first day and the last day of the previous year. It is the aggregate of these three components which would constitute the expenditure in relation to exempt income and it is this amount of expenditure which would be disallowed under Section 14A of the said Act. It is, therefore, clear that in terms of the said Rule, the amount of expenditure in relation to exempt income has two aspects - (a) direct and (b) indirect. The direct expenditure is straightaway taken into account by virtue of clause (i) of sub-rule (2) of Rule 8D. The indirect expenditure, where it is by way of

interest, is computed through the principle of apportionment, as indicated above and, in cases where the indirect expenditure is not by way of interest, a rule of thumb figure of one half percent of the average value of the investment, income from which does not or shall not form part of the total income, is taken.”(emphasis supplied)

In the present case, as submitted above, the assessee suo moto identified expenses having relation with earning of exempt dividend income, viz., Salary of employees engaged in treasury functions and proportionate PMS fees which has been suo moto disallowed in the return of income. Apart from the aforesaid expenses, there is no other expenditure has been pointed out to be related to exempt income in the subject notice after examination and verification of accounts of the assessee.

Further, no portion of the borrowed funds also has nexus with investment in shares resulting in earning of exempt dividend income. The details of interest expenditure incurred during the year are as under:

<i>Particulars</i>	<i>Amount in Rs. (Lakhs)</i>
<i>Interest on Dealer deposits</i>	<i>- 169</i>
<i>Interest on temporary overdraft</i>	<i>- 8</i>
<i>Interest on other statutory dues</i>	<i>- 1013</i>
<i>Total</i>	<i>- 1190</i>

It is submitted that the deposits were received from dealers as part of business transaction with them and such funds were utilized in business operations itself.

That apart, it is submitted that the assessee had substantial free reserves of Rs 4249.89 crores at the beginning of the relevant previous year and had also generated substantial surplus/interest free funds of Rs. 1890.43 crores during the year. Further proceeds from sales of investments were higher than purchases thereof by Rs. 627.85 crores. In such circumstances, it is to be presumed that only interest free funds have been utilized for making investments during the year.

Reliance, in this regard, is placed on the following decisions:

The Supreme Court in the case of East India Pharmaceutical Works Ltd. Vs. CIT: 224 ITR 627, approved the contention of the assessee that,

where interest free funds/ profits available with an assessee are much more than the borrowed funds, it should be presumed that, in essence and true character, the amounts were paid out of the profits of the relevant year and not out of borrowed funds. The relevant observations of the Court are as under:

"Having considered the rival submissions at the Bar, though we find considerable force in the arguments advanced by learned counsel appearing for the appellant, but in the facts and circumstances of the present case, on going through _the order of the Tribunal as well as the question referred by the Tribunal for being answered by the High Court and the arguments advanced before the Tribunal as well as in the High Court by counsel appearing for the assessee, it is not possible for us to hold that any such contention, as was advanced before this court by the assessee had in fact been advanced either before the Tribunal or before the High Court. The question whether a presumption can be drawn that the taxes were paid out of the profits of the relevant year and not out of the overdraft account for the running of the business as was drawn in Woolcombers's case [1982] 134 ITR 219 by the Calcutta High Court and was followed in three other cases of the same High Court, would essentially depend upon the fact as to whether the entire profits had been pumped into the overdraft account, whether such profits were more than the tax amount paid for the relevant year and all other germane factors. But when the assessee never advanced the contention either before the Tribunal or before the High Court and the amplitude of the question posed before the High Court does not bring within its sweep the contention as is advanced by Mr. Bhattacharyya, learned counsel in this court, it would not be appropriate for this court to look into the additional papers produced by the assessee for entertaining the contention and answering the same."
(emphasis supplied)

The Calcutta High Court in the case of Woolcombers of India Ltd. v. CIT: 134 ITR 219 held that where the assessee was having an overdraft account with the bank, in which profits were deposited and such profits exceeded the advance tax liability, it was to be presumed that advance tax was paid out of profits and not out of overdraft account. The disallowance of interest on overdraft related to payment of advance tax was held not to be justified.

The aforesaid decision of the Calcutta High Court in the case of Woolcombers was approved by the Supreme Court in the case of East India Pharmaceutical Works vs. CIT (supra).

The Madras High Court in the case of CIT vs. Hotel Savera: 239 ITR 795 held that where the amount borrowed by a firm were mixed with its own funds and amounts were lent interest free to private companies out of such funds, it could be presumed, in the absence of any nexus having been established between the borrowed funds and the funds lent to private companies, that the advance had been made with firm's own funds, where the firm had sufficient funds to cover the advance. It was, therefore, held that the interest paid on borrowed funds by the firm was allowable in full under section 36(1)(iii) of the Act.

To the same effect are the following decisions:

- CIT v Radico Khitan Ltd: 274 ITR 354 (All)*
- CIT v Dhampur Sugar Mills Ltd: 274 ITR 370 (All)*
- CIT v. United Collieries Ltd. : 49 Taxman 227 (Cal)*
- CIT v. Enamour Investment Ltd.: 72 Taxman 370 (Cal)*
- CIT v. Caroline Investment Ltd.: 87 Taxman 238 (Cal)*
- CIT v. Kanoria Investment {P} Ltd.: 232 ITR 7 (Cal)*
- Tata Fertilizers Ltd. v. DCIT: 92 Taxman (Mag) 423 (Mum)*
- Smt. Chanchal Katyal V. CIT: 207 CTR 154 (All.)*
- DCIT V. Samtel Electron Devices Ltd: 100 TTJ 706 (Del.)*
- Motor General Finance Limited: 267 ITR 381 (SC) followed by Delhi HC in 272 ITR 550.*
- Kumaragiri Textiles Ltd V. DCIT: 100 ITD 57 (Chennai) (TM)*
- CIT v. Reliance Utilities and Power Ltd.: 313 ITR 240 (Bombay HC)*

On the basis of the ratio of the aforesaid decisions, and having regard to the facts of the case, interest free funds available with the assessee were used for making investments and, accordingly, no portion of the interest expenditure incurred during the year could also be said to have been incurred in relation to earning of exempt income, warranting rejection of disallowance computed by the assessee and adopting recourse to provisions of Rule 8D of the Rules.

19.3 Findings;

i. *Argument of the assessee is that no expenditure was incurred to earn the exempt income. It has just considered salary of two staff members Rs. 44, 73,323/- and portfolio management fees Rs. 20,49,692/- as expenditure attributable to earn exempt income. This appears to be a proposition where assessee is trying to make a case that all decisions with*

regard to the extent of investment, nature of investment, period of their holding etc. are decided by these two employees. The fact is that when the investment is running into hundred of crores and turnover in thousands of crores of rupees, it is decision of the management, to invest, continue therein, exit there from or to deal with that in the manner as decided by them. These two employees could be instrumental in only in managing the accounts but in no way in having a say in decision making. It is conscious decision of the management to make these investment, continue therein, deal with that and exit therefrom. Therefore, there is inherent cost of business establishment and control and management.

ii. Coming next to the impugned disallowance u/s 14A of the Act, it is a fact that expenditure under the head administrative expenditure for earning dividend income cannot be ruled out. While allocating expenses relating to exempt income not only the direct expenses like receiving and depositing the dividend warrant has to be taken into consideration but also the indirect expenses including major managerial/ clerical expenses which are involved in making and implementing the decision are also to be taken note of. The disallowance of administrative expenses and interest expenses on earning of exempted income is also held/permitted by the Hon'ble Supreme Court in the case of CIT vs. United General Trust, 200 ITR 488 (SC).

iii. The assessee company has earned exempt income amounting Rs 11.54 crores on non trade current investment made by it in mutual funds, shares and bonds as per schedule of the accounts.

iv. The decisions of investments in shares/mutual funds are vigil and updated ones. Further equity oriented mutual fund schemes are prone to market forces, in the same manner, debts oriented mutual funds scheme are subject to market fluctuation and their NAV also changes according to the given market sentiment.

v. This fact that diversified investment in mutual funds revealed whole, that would suggest that considerable time, effort, application of skills, technical knowledge, expertise etc. have gone in toward these investments.

vi. The assessee company has total profit before tax Rs. 2,529.20 Crores and total exempt income is Rs. 11.54 crores. For both income major expenses are audit expenses, which is Rs. 126 lacs, as the auditor of the company audited all the 'transaction recorded in the books of account either for turnover or for sale of securities. There are some other expenses at HO like Postage & telegram Rs. 55.82 lacs, Printing & stationary Rs. 61.43 lacs, Telephone & Telex Rs. 289.22 lacs, Director sitting fees Rs. 15.00 lacs, and misc expenses Rs. 87.98 lacs. All the expenses are directly related to the total income of the company.

Section 14A has been inserted by the Finance Act 2001, w.r.e.f. 1.4.62. Section 14A has been amended by section 10 of the Finance Act 2002 and again by section 7 of the Finance Act, 2006.

The CBDT issued Notification No.45 dated 24.3.2008 incorporating Rule 8D pertaining to the "method of determining amount of expenditure in relation to income not includible in total income".

CBDT has also issued Circular No. 5/2014 wherein it is stated that "the matter has been examined in the Board. It is pertinent to mention that section 14A of the Act was introduced by the Finance Act, 2001 with retrospective effect from 01.04.1962. The purpose for introduction of section 14A with retrospective effect since inception of the Act was clarified vide Circular No. 14 of 2001 as under: "Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect means that the tax incentive given by way of exemptions to certain categories of income is being used to reduce also the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income. This is against the basic principles of taxation whereby only the net income, i.e. gross income minus the expenditure, is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income." Thus, legislative intent is to allow only that expenditure which is relatable to earning of income and it therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial-year or not. The above position is further clarified by the usage of term 'includible' in the Heading to section 14A of the Act and also the Heading to Rule 8D of IT Rules, 1962 which indicates that it is not necessary that exempt income should necessarily be included in a particular year's income, for disallowance to be triggered. Also, section 14A of the Act does not use the word "income of the year" but "income under the Act". This also indicates that for invoking disallowance under section 14A, it is not material that assessee should have earned such exempt income during the FY under consideration. The above

position is further substantiated by the language used in Rule 8D[2(ii) & 8D(2)(ii) of the IT Rules which are extracted below:-

"(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt an amount computed in accordance with the following formula, namely:- $A*B/C$ where B= the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous years;(iii) an amount equal to one-half percent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year." (Emphasis added) thus, in light of above, Central Board of Direct Taxes, in exercise of its powers under section 119 of the Act hereby clarifies that Rule 8D r.w. section 14A of the Act provides for disallowance of the expenditure even where taxpayer in a particular year has not earned any exempt income."

- The provision of sub-section (1) of Section 14A provides;
"14A. 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."
- The term "expenditure" occurring in Section 14A would take in its sweep not only direct expenditure but also all forms of expenditure **regardless of whether they are fixed, variable, direct, indirect, administrative, managerial or financial.**
- As regards the applicability of Rule 8D of the I.T. Rules, the Hon'ble ITAT in the case of **Citicorp Finance (I) Ltd.** Held that " It is no longer open to the Assessing Officer to apply his discretion in computing the disallowance or make adhoc disallowance u/s 14A" as " ... sub sections (2) and (3) seek to achieve the underlying objection of section 14A(1) that any expenditure incurred in relation to exempt income should not be allowed deduction".
- The earning of exempt income is not in the nature of passive activity having no input. In fact in present situation making of investment, maintaining or continuing investment and time of exit from the investments are well informed and well coordinate management decisions involving not

only inputs from various source but also acumen of senior management functionaries. Therefore cost is inbuilt into even so called "passive" investment. Incidental expenditures in this regard are bound to be incurred in collection, telephone, follow-up even directors time and energy etc. Assessee Company's claim that it has not incurred any expenditure is not acceptable as expenditures incurred for earning of exempted income are embedded in indirect expenditures.

- The investments made, being a conscious decision and having deployment of funds clearly brings into picture expenditure by way of cost of funds invested.
- The Hon'ble Bombay High Court, in its judgment delivered on 12.08.2010 in ITXA No. 626/2010 & Writ Petition No. 758/2010 in the case of **Godrej & Boyce Manufacturing Co. Limited, Mumbai vs. Dy. CIT-10(2), Mumbai & others**; has ruled in favour of the Department as regards the applicability of Rule 8D for and from A.Y. 2008-09 onwards.
- The assessee's plea that it has not earned any exempt income on its investments, hence the provision of Section 14A is not applicable to its case, is not acceptable in view of the clear position of law that the nomenclature of the heading before Rule 8D of the Rules, 1962 provides for 'method for determining amount of expenditure in relation to **income not includible in total income**'. The words used are "**income not includible in total income**", it is not "**income not included in total income**". There is a difference between the terms "**not includible**" and "**not included**" as such. Moreover, part 'B' of clause (ii) of sub-rule (2) of Rule 8D also prescribes the average of value of investment, income from which **does not or shall not form part of the total income**, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year. Thus, the intent of legislature is very much clear from the wordings used in the heading as well as Rule 8D itself so as to cover all the investments which might generate such an income either in the present or even in future, which is not includible in total income of the assessee.
- If there is material to establish that there is direct nexus between the expenditure incurred and the income not forming part of total income, disallowance would be justified **even where there is no receipt of exempt income u/s 10** in the year under consideration, in view of the latest decision of the Hon'ble Delhi ITAT vide order dated 09.01.2012 for A.Y. 2008-09 in the case of **Technopak Advisors Private Limited [2012] 50 SOT 31**, wherein it has been held that **as per provisions of Section 14A**,

actual earning of income is not sine qua non for deciding deduction of expenditure laid out or expended wholly or exclusively for purpose of such income. The Hon'ble Tribunal adjudicated upon the question of law in affirmative as to whether, where investment had been made in shares, which did not yield any dividend in the year under consideration, expenditure incurred for earning income was deductible **notwithstanding the fact that no such income had been earned.**

- Hon'ble Supreme Court in the case of CIT Vs. United General Trust Ltd., 200 ITR 488 (SC) has held that expenditure in relation to earning of exempt income are embedded in the indirect expenditures. Accordingly the claim of the assessee that it has not incurred any expenditures in relation to earning of the exempted income is not acceptable.

Further, The following instances will clarify the situation regarding the quantum and the accrual of income being of no relevance/cannot be of relevance to the disallowance of expenditure in question

1. Two assessees namely A & B both borrow capital of 100 crores @ 12% and invest in two different shares of company C and D respectively. The company C doesn't declare dividend whereas the Company D declares a dividend of 1 Crore. The assessee's argument tend to lay down that no disallowance has to be made if no dividend income has been received by the assessee

Now, both the companies A & B have incurred an expenditure of Rs. 12 crore on the said investment. The assessee's argument effectively proposes a theory of penalizing the company B selectively for earning the dividend. The company A will be allowed the interest expenditure of Rs. 12 crore and no disallowance would be made in the case of company A as no dividend has accrued to it, whereas in the case of company B the interest expenditure of Rs. 12 crore will be disallowed. The above leads to a prima facie fallacy of such a conclusion, for which the Act doesn't intend in law . Therefore, the quantum of income has no role to play, rather cannot play a role in the determination of disallowance u/s 14A. r.w Rule 8D

2. Let us consider another situation in which two assessees namely A & B both borrow capital of 100 crores @ 12% and invest in shares of company D respectively. The company D declares dividend of Rs. 1 crore. The entity A follows cash system of accounting and the entity B follows mercantile system of accounting and because of which the situation arises that the

entity A accounts for dividend in the subsequent year on receipt basis, let say financial year 2015-16 and the entity B accounts for the same on accrual basis in financial year 2014-15, if the assessee's arguments are to be followed, in the case of entity A no disallowance can be made in FY 2014-15 and disallowance can be made in FY 2015-16 whereas in entity B disallowance can be made in FY 2014-15 and not in FY 2015-16, in spite of the fact that both the entities have incurred interest expenditure for both the years under consideration and for the same dividend declared and the same investments, the disallowance takes place selectively in a particular year which leads to again a fallacy.

3. Let us consider another situation in which two assessees namely A & B both borrow capital of 100 crores @ 12% and invest in shares of company C & D respectively. Both incur an expenditure of Rs. 12 crore for the year. The company C declares a dividend of Rs. nil and the company D declares a dividend of Rs. 12 crores. The assessee's argument tend to limit the disallowance to the income earned (in most of the cases the quantum of dividend is not in control of the assessee and the assessee can't be said to have a role as such regarding the quantum), therefore in the case of A the sum of Rs. 12 crores being the deficit will be allowed as a business expenditure, when the same was directly related to the earning of exempt income, thus again leading to a fallacy, when both the assessee basically invested same quantum at the same rate of borrowings and **also a fallacy of creating an impression that an expenditure will just become a business expenditure of the assessee just for the want of exempt income and the quantum of exempt income will govern the allowance and quantum of an expenditure to be characterized as a business expenditure inspite of the fact that it has no relation. Thus, just because no dividend was accrued, the same expenditure became a business expenditure & thus brings out the fallacy in the argument of no dividend implies no disallowance.**

The above examples, which are simple in nature only tend to bring about the implication of assessee's argument, leading to a the flawed and varied treatment of the disallowance of same interest expenditure on same investments as a measure of situation, accounting, quantum and accrual of exempt income i.e dividend

The neutrality of the Income Tax Act regarding the quantum of income and its accrual is very clearly brought out in the section 14A and also the intent is supported by the mechanism of disallowance provided in rule 8D.

Further, the rule 8D which prescribes a method of disallowance (reproduced as under)

- 1. Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with:*
 - a. The correctness of the claim of expenditure made by the assessee or*
 - b. The claim made by the assessee that no expenditure has been incurred,*

In relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule{2).

2.) the expenditure in relation to income which does not form part of the total income shall be the aggregate of following amount, namely-

- (i) the amount of expenditure directly relating to income which does not form part of total income.*
- (ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely-*

$$A \quad X \quad \frac{B}{C}$$

Where A = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year.

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year:

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day of the last day of the previous year:

- (iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall no form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.*

(3) For the purpose of this rule, the "total assets" shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets

The above rule for the purpose of disallowance is very clear that what is material aspect is the quantum of expenditure incurred in relation to the quantum of investment made and there is no whiff of the quantum of income generated by these investments. Therefore, the section 14A and consequent rule 8D in unison very clearly and unambiguously lays down the intend of the statute for making a disallowance.

The Apex Court by admitting SLP in case of Tulip Star Hotel Ltd, wherein it was pronounced as under:-

“ Issue notice on the applications for condonation of delay as also on the special leave petitions. In our view, S.A. Builders Ltd. vs. Commissioner of Income-Tax (Appeals) and Another, reported in 288 ITR 1, needs reconsideration.” Which considers that the question of allowability of interest is open for consideration still

The aforesaid provisions are procedural in nature and the disallowance u/s 14A is, therefore, computed in accordance with Rule 8D.

In view of the above, the explanation furnished by the assessee is not fully acceptable.

Therefore, the undersigned has to apply the rule 8D for making disallowance u/s 14A.

Here it may be pointed out that the insertion of Section 14A of the Act and subsequent introduction of Rule 8D are meant to clear the ambiguity with regard to expenditure relatable to earning of exempt income. The provisions are basically addressing the extent of funds having been managed for such investment, expenditure directly relatable to such earnings and interest charged to P/L account, in case not directly relatable to any particular income or receipt. In the absence of any scientific working on part of the assessee to allocate expenses relatable to exempt income and mere claim that no expenditure was incurred to earn the exempt income, the Assessing Officer is left with no alternative but to work out the same. Since any other working of expenditure relatable to exempt

income will be mere estimate, it is necessary to invoke Rule 8D to work out such a disallowance.

Furthermore, having regard to the accounts of the assessee of the previous year, AO is not satisfied with the claim made by the assessee that no expenditure has been incurred in relation to income which does not form part of the total income of the previous year relevant to the assessment year under consideration and, therefore, the amount of expenditure in relation to such income is determined in accordance with the provisions of sub-rule (2) of Rule 8D of the IT Rules, 1962.

Particulars			Amount (in lacs)
Expenditure directly related to exempt income	-	-	0
Disallowance of interest expenditure			
A. Interest expenditure incurred during the year	1191.00		
Less: Disallowed in return	NIL		
	1191.00		
B. Average Value of investment	21,156.50		
C. Average of total assets	9,76,528.50		
Disallowance = A* B/C		25.80	25.80
Aggregate of Opening and closing value of Investment (Average Value of Investment) ½% of above as per Rule 8D			105.78
Total disallowance [Aggregate of (i), (ii) & (iii)]			131.58

Since the assessee has already worked out disallowance u/s 14A at Rs. 65.23 lacs, effect thereof is given here and net disallowance of Rs. 66.35 lacs is being made and proposed to be added to the income of the assessee.

The Hon'ble DRP vide its order dated 21.09.2017 has decided this issue in favour of Revenue giving a detailed reasoning which is part of the DRP order and not reproduced for the sake of brevity. Accordingly in conformity with the order of DRP, disallowance of Rs. 66,35,000/- is being made and added to the total income of the assessee under normal provisions as well as income computed u/s 115JB. I am satisfied that the assessee company has filed inaccurate particulars of income in respect of this issue with regards to income under normal provisions of the Act as

well as income u/s 115JB. Penalty proceeding u/s 271(1)(c) is initiated separately.

(Addition of Rs. 66,35,000/-)

Without prejudice to the above, the above interest expenses are not eligible u/s 36(1)(iii) and the maintenance of investment cost as computed above not eligible u/s 37(1).

The assessee has made sizable investments in various entities, the assessee has claimed a sizable amount of interest expenditure u/s 36(1)(iii).

The deduction of interest to the assessee under the head income from business and profession is allowed u/s 36(1)(iii) of the Income Tax Act, 1961, which reads as under:-

"The amount of interest paid in respect of capital borrowed for the purpose of business and profession"

Therefore the interest has to be allowed only if the capital deployed is for business and profession. It is important to note that the claim of interest u/s 36(1)(iii) is of the assessee and it has to be justified for the purpose of business by the assessee. The onus is on the assessee and not of the department to justify its claim of interest, and if the assessee fails to do so, if on account of mixed funds, the A.O has all the right to estimate such allowability and on direct nexus the same has to be disallowed.

The assessee in the present case has made investments in shares and securities and has advanced share application money for investment in shares, the income generated from such investments has to be accounted under the following heads:

1. Capital gains.
2. Income from other sources.

The income from capital gains arises from the transfer of the asset held as investment and depending on the period of holding, the indexation as applicable is allowed as a sort of compensation for the period of holding.

The provisions from section 45 to 55A for computation of income under the head capital gains do not allow for any deduction of interest paid on the capital deployed for such an asset. The section 48 (i) and 48(ii) do not allow for interest as an expenditure. However, the second proviso of

section 48 provides for indexation of cost and improvement incurred in connection with the long term capital asset.

The capital gains is attracted only on a transfer of the investment, therefore once the assessee decides to hold a particular asset as investment, it cannot claim any interest u/s 36(1)(iii), whether or not the transfer take place during the year

Therefore, as any investment made by the assessee out of the borrowed capital does not attract the head income from business and profession and therefore, as a natural corollary no interest expenses can be allowed on /in relation to such investments under section 36(1)(iii) and no interest is allowable u/s 45 to 55A as discussed above.

The investments besides generation of income under the head capital gains on account of transfer can only generate an income under the head income from other sources in the form of dividend. The deduction for interest is provided u/s 57 of the Income Tax Act, if the dividend falls as income u/s 56(1)(i) of Income Tax Act. The dividend from the shares and securities have been specifically made exempt u/s 10(34), 10(34A), etc., and as the dividend from domestic companies has been specifically made exempt u/s 10(34) -of the Income Tax Act. Therefore, the investments made in shares and securities and the dividend yield -from the same being exempt from tax because of specific provision of the Act would not attract the head of income from other sources. The department, therefore cannot invoke the provision of section 56(1) under the head of income from other sources in the case of such investments and the assessee has also been thus snatched away from the deduction of relevant interest u/s 57 of the Act accordingly.

Therefore, the assessee in case of the domestic investments in shares and securities cannot claim deduction of such interest u/s 36(1)(iii) and also is not allowed deduction of such interest u/s 57 or u/s 48 (which anyway does not provide interest deduction.

The general and administrative expenses claimed u/s 37(1) and incurred by the assessee, to the extent relatable to investment is also be disallowed invoking the same arguments as stated above as being not allowable u/s 57 or u/s 48 as the case may be.

In view of the above, disallowable quantum u/s 36(1)(iii) of interest of Rs 25.80 lacs and the expenditure to be disallowed u/s 37(1) (105.78

lacs-65.23 lacs)=40.55 lacs for carrying the investment is calculated and proposed to be disallowed as under

Disallowance of interest on an average basis and mixed funds).

Interest paid x total average investment / total

average assets.

Rs. 25.80 lacs

Disallowance under 37(1) being half percent of average investments

Rs. 105. 78 lacs

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Since the assessee has already worked out disallowance at Rs. 65.23 lacs, effect thereof is given here and net disallowance of Rs.25.80 lacs u/s 36(1)(iii) and Rs. 40.55 lacs u/s 37(1) is being made and proposed to be added to the income of the assessee. I am satisfied that the assessee company has filed inaccurate particulars of income with respect to this issue. Penalty proceeding u/s 271(1)(c) is initiated separately.

(Addition of Rs. 66,35,000/-)”

It is the complete substance of the order which has to be taken into consideration. The figures mentioned in the aforesaid reasoning comes from the accounts of the appellant assessee itself.

We clarify that we have not examined merits of proposed question (F) for which the assessee has filed the miscellaneous application before the Tribunal. We grant liberty to the appellant to file a fresh appeal in case the miscellaneous application is dismissed by the Tribunal.

SANJIV KHANNA, J.

ANUP JAIRAM BHAMBHANI, J.

JANUARY 11, 2019

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