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

\+ ITA No. 1272/2018

HERO MOTOCORP LTD. ..... Appellant

Through : Mr. Ajay Vohra, Sr. Adv. with Mr. Aniket D. Agrawal & Ms. Deepika Agarwal, 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

O R D E R

% 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:-

> *"**22. Disallowance u/s 14A; Rs. 62,30,000/- ;***
> *22.1 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.*

22.2 Assessee's submission:

During the relevant previous year, the assessee company earned dividend/interest income of Rs. 11.02 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. 70.76 lacs, in the return of income filed for the relevant assessment year.

While computing the amount of disallowance of Rs. 70.76 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*	*883,618*	*100%*	*883,618*
4023	*Ashish Mishra*	*DGM*	*Partly*	*3,328,282*	*100%*	*3,328,282*
				4,211,900		*4,211,900*

Further entire Protfolio management fees Rs. 28,64,867/- 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:*

> *"........*
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> *Thus, we will have to consider the argument of the asssessees 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.*
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> *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:-*
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>> *"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 Section14A 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 proprortionate 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:

Particulars	*Amount in Rs. (Lakhs)*
Interest on Dealer deposits	*157*
Interest on temporary overdraft	*5*
Interest on late deposit of TDS (already disallowed in return)	*671*
Interest on other statutory dues and Payments to vendor	*1297*
Total	*2130*

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 2916.12 crores at the beginning of the relevant previous year and had also generated substantial surplus/interest free funds of Rs. 2359. 78 crores during the year. Further proceeds from sales of investments were higher than purchases thereof by Rs. 92.79 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.

24.3 ***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.42,11,900/-and portfolio management fees Rs. 28,64,867/- 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. 11.02 crores on non trade current investment made by it in mutual funds and shares 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. 2,864.77 Crores and total exempt income is Rs. 11.02 crores. For both income major expenses are audit expenses, which is Rs. 58.09 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. 51.23 lacs, Printing & stationary Rs.

64.40 lacs, General administrative expenses Rs. 315.25 lacs, Telephone & Telex Rs. 226.16 lacs, Director sitting fees Rs. 14.00 lacs, and misc expenses Rs. 44.64 lacs. All the expenses are directly related to the total income of the company.

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	2130.00		
Less: Disallowed in return	NIL		
	2130.00		
B. Average Value of investment	18,831.50		
C. Average of total assets	10,30,759.00		
Disallowance = A* B/C		38.91	38.91
Aggregate of Opening and closing value of			94.16

Investment (Average Value of Investment) ½% of above as per Rule 8D			
Total disallowance [Aggregate of (i), (ii) & (iii)]			**133.07**

Since the assessee has already worked out disallowance u/s 14A at Rs. 70.77 lacs, effect thereof is given here and net disallowance of Rs. 62.30 lacs is being made and added to the income of the assessee.

The Hon'ble DRP vide its order dated 21.12.2016 has decided this issue in favour of Revenue. Accordingly in conformity with the order of DRP, disallowance of Rs. 62,30,000/- is being made and added to the total income of the assessee. I am satisfied that the assessee company has filed inaccurate particulars of income and concealed the income with respect to this issue. Penalty proceedings u/s 271(1)(c) have been initiated separately.

(Addition of Rs 62,30,000/-)

23. ***Expenses at Head Office towards Cost of Inventory, Rs. 66,84,000/-***

23.1 The assessee has valued semi finished goods and finished goods inventory at the raw material cost and allocated production overheads of respective units on closing inventory. However assessee has not considered expenses incurred at head office towards the valuation of inventory. Closing stock valuation is accordingly required to be modified. Therefore - assessee was required to show cause why the valuation of inventory not be enhanced on account of non inclusion of HO expenses."

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 may also record that the question of merits of the deduction under Section 80D has been remitted by the Tribunal to the Assessing Officer for fresh consideration.

With regard to the proposed question (F), learned senior counsel for the appellant submits that they have filed a miscellaneous application before the Tribunal which is pending. He submits that liberty may be granted to the appellant to file a fresh appeal after the miscellaneous application is decided.

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.

Recording the aforesaid, the appeal is dismissed on the question relating to Section 14A of the Act. Question (F) is left open to be decided if required by way of a fresh appeal. For record, present appeal would be treated as disposed of. No costs.

SANJIV KHANNA, J.

ANUP JAIRAM BHAMBHANI, J.

JANUARY 11, 2019
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