

IN THE HIGH COURT OF GUJARAT AT AHMEDABAD**TAX APPEAL NO. 603 of 2013**

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COMMISSIONER OF INCOME TAX AHMEDABAD IV....Appellant(s)

Versus

TORRENT POWER LTD....Opponent(s)

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Appearance:

MR.VARUN K.PATEL, ADVOCATE for the Appellant(s) No. 1

MR B S SOPARKAR, ADVOCATE for the Opponent(s) No. 1

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CORAM: **HONOURABLE MR.JUSTICE AKIL KURESHI**
and
HONOURABLE MS JUSTICE SONIA GOKANI

Date : 04/02/2014

ORAL ORDER**(PER : HONOURABLE MS JUSTICE SONIA GOKANI)**

1. Challenging the order of the Income Tax Appellate Tribunal, present Tax Appeal under section 260A of the Income Tax Act ("the Act" here-in-after) preferred by the Revenue proposing the following substantial questions of law for our consideration :

“(i) Whether in the facts and circumstance of the case, the learned ITAT has erred in law in allowing the appeal of the assessee by deleting the disallowance made by the Assessing Officer u/s.14A of the Income-Tax Act as confirmed and enhanced by the CIT(A)?

(ii) Whether in the facts and circumstances of the case, the learned ITAT has erred in law in holding that the

provisions of Rule 8D were applicable prospectively and not retrospectively?

(iii) Whether the assessing officer is empowered to make disallowance u/s 14A of the Income Tax Act by bifurcating the expenditure in a reasonable manner towards earnings the taxable income and exempt income even in absence of Rule 8D of Income Tax Rules?”

2. We have heard learned counsel Shri Varun Patel for the appellant and Shri Bandish Soparkar for the assessee respondent.
3. This appeal arises in the following factual background. The assessee for the assessment year 2006-2007, filed the return of income. A notice was issued under section 143(2) of the Act by the Assessing Officer calling for certain details. The assessee had shown the exempt income being tax free interest on bonds, exempted under section 10(15) to the tune of Rs. 1.01 crores (rounded off) and dividend exempt under section 10(23D) of Rs.12.98 crores(rounded off), the total sum worked out to Rs. 14 crores (rounded off). The Assessing Officer had sent show cause notice as to why the disallowance under section 14A would not be made in this case. According to the assessee, it had huge amount of interest free funds and no part of expenditure also was incurred towards the investment activity. The Assessing Officer after considering in detail the submissions, was of the opinion that the interest relatable to the earning of tax free income was not allowable under section 14A. It also objected to interest bearing loan and financial charges to the tune of 43.4%, amount which reduced the business profit. A reasonable figure of 1% of

the said interest expenditure which worked out to Rs.43.47 lacs was disallowed under section 14A and added back the said amount to the total income of assessee.

4. CIT(Appeals) was approached by the assessee challenging such addition on part of the Assessing Officer. It held that :

“3.3 I have considered the facts of the case and the submissions of the appellant. I am not inclined to accept the contentions of the appellant. The A.O. very reasonably and justifiably considered the facts in the case of appellant and held that “the details furnished by the assessee regarding the mutual fund transactions clearly show a high-frequency redemption which require constant monitoring and follow-up. Therefore, it becomes imperative that some part of the expenses incurred on employee remuneration and administrative expenses is attributed to the earning of dividend income.” There is various laws, which held accordingly that for such activities, there can be both direct and indirect expenses in the nature of administrative and establishment cost cannot be denied altogether as submitted by appellant.”

5. Following the judgement of ITAT Special Bench, Mumbai in the case of M/s. Daga Capital Management Pvt. Ltd., and others (order dated 20-10-2008) where it examined the background which led to the insertion of the section 14A by the Finance Act, 2001 and held the same to be retrospective having effect from 01-04-1962, it held against assessee thus :

“It is therefore the Assessing Officer, is not justified in disallowing expenditure on proportionate basis. After drawing his satisfaction that appellant has not disallowed

any expenditure u/s14A of the Act, but there is indirect cost and other such cost, the AO should have computed the disallowance as per Rule 8D of the IT Rules. The appellant's two arguments that (a) exempt income of Rs.6.12 cr. is related to 'Sugen Project' which is still under construction and all the expenditure related to it were not claimed but capitalised, hence provisions of sec.14A of the Act cannot be applied since expenditure incurred in relation to income that does not come within the scope of total income. (b) The AO has not established any nexus between the utilisation of borrowed funds and earning of dividend income, which is a pre requisite to the application of section 14A of the Act, are required to be analysed in view of the Daga capital case, supra. The appellant relied on various case laws for these two main arguments, but with due respect, this latest judgement by the Hon'ble ITAT Mumbai Special Bench has considered all such aspects and case laws.

The disallowance u/s 14A of the Act has therefore, to be computed as per Rule 8D of the I.T. Rules, as under :-

As per Rule 8D(2):

i)	Direct amount of expenditure relating to exempt income	NIL
ii)	Out of interest which is not directly attributable to any particular income or receipt as per formula	NIL since AO has not attached such attributability and only administrative expenditure were found to be disallowed.
iii)	0.5% of the average value of investment i.e. 0.5% of $\frac{1}{2}$ (19510.37+0)	Rs.4877592

It is therefore, the total disallowance is the aggregate of (i) + (ii) + (iii) i.e. Rs.48,77,592. The AO has disallowed only Rs.43,47,000/-. Therefore, there is enhancement of disallowance and thereby total income to the extent of

Rs.5,30,592/- (48,77,592-43,47,000). The appellant's ground of appeal on this issue is rejected with enhancement."

6. This was when carried to the Tribunal by the assessee being aggrieved by the findings of the CIT(Appeals), the Tribunal upheld the say of the assessee by holding that disallowance of 1% of interest expenses made for earning exempt income by the Assessing Officer and disallowance made under section 14A by the CIT(Appeals), by following the method prescribed under Rule 8D of the Income Tax Rules, 1962, was not found sustainable. The tribunal held thus :

"Considering the totality of facts and more so in view of the fact that the applicability of rule 8D is applicable from AY 2008-09 and in the present case since the AY involved is 2006-07, we are of the view that no disallowance can be made by applying the provisions of rule 8D. We further find that AO had disallowed 1% of the interest expenses on adhoc basis and the same was enhanced by CIT(A) by following the method prescribed under Rule 8D. AO has not pin pointed any expenditure which the assessee had incurred for earning exempt income. We also find support to our reasoning by the ratio laid down by Hon'ble Delhi High Court in case of Maxopp Investments Ltd. (supra). We therefore, considering the totality of facts are of the view that the addition needs to be deleted. Thus this ground of the assessee is allowed."

Therefore, the present appeal.

7. We could notice from the record that the assessee was having share holding funds to the extent of 2607.18 crores and the investment made by it was to the extent of

Rs.195.10 crores. In other words, the assessee had sufficient funds for making the investments and it has not used the borrowed funds for such purpose. This aspect of huge surplus funds is not disputed by the Revenue which earned it the interest on bonds of dividend income.

8. With regard to disallowance of 1% of administrative expenses averred to have incurred on account of the earning of interest, there is nothing on record to indicate that there has been in fact any actual expenditure incurred by the assessee for earning tax free income of Rs.14 crores. It is also to be noted that out of the total amount of exempt income of Rs.14 crores, the assessee could point out that 6.12 crores(rounded off) was earned by Sujen project which was under construction for which no expenditure had been claimed and for the remaining income of Rs.7.88 crores which consist of dividend and tax free interest, no part of expenditure appears to have been made towards the investment activity as emerging from the material. According to the respondent, the total investment from the huge surplus is comparatively small and investment made was effortless, without any burden of administrative expenses.

9. We notice that this Court in case of **Commissioner of Income-tax IV v. Suzlon Energy Ltd** reported in (2013) 33 taxman.com 151 (Gujarat), has dealt with identical issue. The reasons given therein in detail profitably require to be reproduced at this stage :

“Question [2] pertains to disallowances made by the Assessing Officer under Section 14A of the Act in respect of

interest expenses incurred for investments made in subsidiaries and administrative expenses. CIT [A] deleted such disallowances, upon which, Revenue approached the Tribunal. The Tribunal rejected Revenue's appeal, making following observations :

“3.5 We have considered the rival submissions, perused the material on record and have gone through the orders of authorities below. Regarding the grounds raised by the revenue in respect of disallowance of interest expenditure made by the A.O under Section 14A and deletion made by learned CIT (A), we find that no interference is called for in the order of learned CIT (A). We hold so because we find that with regard to the investment of Rs. 5907.18 lacs in foreign subsidiaries, no disallowance can be made u/s. 14A because dividend income from foreign subsidiaries is taxable in India. Regarding balance investment of Rs. 38 crores approximately in Indian subsidiaries, we find that interest free own funds of the assessee is many time more than this investment because interest free funds available with the assessee as on 31.03.2005 as per the balance sheet as on that date is of Rs. 929.57 Crores. There is no finding given by the A.O regarding any direct nexus between interest bearing borrowed funds and investment in Indian subsidiaries. Hence, in our considered opinion, no disallowance u/s. 14A can be made out of interest expenditure in the facts of the present case. Accordingly, ground no. 2 & 3 of the Revenue's appeal are rejected.”

3.1 From the above portion, we noticed that the Tribunal has bifurcated the expenditure in two parts – first related to investment of Rs. 5907.18 lakhs in foreign subsidiaries, it was held that the dividend income from such subsidiaries is taxable in India and that therefore, Section 14A would have no applicability. The remaining amount pertain to investment of Rs. 38 Crores [rounded off] made in Indian subsidiaries. In this respect, the Tribunal noted that the assessee had to its disposal, own interest free

funds many times over the investment in question. As per the balance sheet as on 31st March 2005, the assessee had interest free fund of Rs. 929.57 Crores.

Such being the facts, the Tribunal, in our opinion, committed no error. No question of law, therefore, arises.”

10. In Tax Appeal No.118/2013 in case of **Commissioner of Income Tax v. UTI Bank**, the issue pertaining to disallowance under section 14A and interpretation of Rule 8D of the Income Tax Rules was decided in favour of the assessee and against the department holding therein that in absence of any finding as to how the administrative expenses have been incurred to earn the exempt income, disallowance made by the Assessing Officer was not sustainable. Punjab and Haryana High Court in case of **Commissioner of Income-tax v. Hero Cycles Ltd.** reported in (2010) 323 ITR 518 (P&H) was dealing with a case where the Tribunal had deleted the disallowance of huge sum under section 14A of the Act by holding that a clear nexus was not been established that the interest bearing funds have been invested for generating tax free dividend income. The Tribunal had held that there was no nexus between the expenditure incurred and the income generated where the assessee had earned the dividend income which was exempted under section 10(34) and (35).

When the matter travelled to High Court, the High Court while dismissing the appeal held that the expenditure on interest was set off against the income from interest and the investment in the shares and funds were out of the dividend proceeds and in such set of facts,

disallowance under section 14A was not sustainable. It further held that whether in a given circumstances any expenditure was incurred which was to be disallowed, was a question of fact. The contention of the Revenue that directly or indirectly some expenditure was always incurred which must be disallowed under section 14A and the impact of expenditure so incurred could not be allowed to set off against the business income which may nullify the mandate of section 14A, was not accepted. Disallowance under section 14A required finding of incurring of expenditure and where it was found that for earning exempted income, no expenditure had been incurred, disallowance under section 14A could not stand. Accordingly, such disallowance was not permitted.

11. We notice that this appeal concerns the year 2006-2007 and the application of Rule 8D of the Income Tax Rules has come into being from 2007-2008 which has been held prospective by this Court, following the judgement of Bombay High Court in case of **Godrej and Boyce Mfg. Col. Ltd v. Deputy Commissioner of Income Tax and another** reported in (2010) 328 ITR 81(Bom), where Bombay High Court has quashed the order and judgement of Special Bench rendered in **M/s.Daga Capital**(supra), this Court in case of **Commissioner of Income-tax IV v. Sintex Industries Ltd.** reported in (2013) 33 taxmann.com 240(Gujarat), was considering the issue pertaining to disallowance of part of remuneration paid to the Directors. The Assessing Officer noted the fact that the assessee had earned exempt income under section 10(35) of the Act arising out of Mutual Fund Investment and, therefore, held

the opinion that the expenditure incurred for earning exempt income should be disallowed under section 14A of the Act and when no bifurcation was made by the assessee, the Assessing Officer disallowed the total expenditure under such head and added back the entire sum being the amount of salary of the Directors to the income of the assessee. Both the tribunal and the Commissioner did not approve such decision, relying on judgement of Bombay High Court in case of **Godrej & Boyce Mfg. Co. Ltd** (supra) by holding that in absence of Rule 8D of the Income-tax Rules, no disallowance can be made under section 14A of the Act. When such decision was under challenge before this court it held thus :

“4. With respect to proposition that Rule 8D is not retrospective in operation, we have no hesitation in agreeing with the decision of the Bombay High Court in the case of Godrej Boyce & Manufacturing Co. (supra). Previously also, we had occasion to deal with the said Rule and held as and the Bombay High Court has done. That, however, does not mean in our prima-facie opinion that no disallowances can be made under Section 14A of the Act by bifurcating the expenditure in a reasonable manner towards earning of the taxable income and tax exempt income.

5. In the present case, since the amount involved is not very large, we reserve our final conclusion on such an issue in appropriate case. Therefore, we are not inclined to entertain this Tax Appeal. However, we should not be seen to have confirmed the Tribunal's view on the aspect that in absence of Rule 8D, no disallowances can be made under Section 14A of the Act, by proportionate bifurcation of the expenditure.”

12. In the instant case, however, as discussed here-in-above, it clearly emerges from the material on record that no expenditure was incurred for earning exempted income and that being the question of fact, we hold that disallowance of 1% of interest expenditure artificially or on the basis of assumption rightly has not been sustained by the Tribunal.
13. This tax appeal therefore, requires no further entertainment and hence dismissed.

(AKIL KURESHI, J.)

(MS SONIA GOKANI, J.)

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