

IN THE HIGH COURT OF KERALA AT ERNAKULAM

ITA.No. 467 of 2009()

THE COMMISSIONER OF INCOME TAX,TRICHUR

... Petitioner

Vs

THE CATHOLIC SYRIAN BANK LTD.,TRICHUR

... Respondent

For Petitioner: SRI.JOSE JOSEPH, SC, FOR INCOME TAX

For Respondent: SRI.K.VINOD CHANDRAN

The Hon'ble MR. Justice C.N.RAMACHANDRAN NAIR

The Hon'ble MR. Justice K.SURENDRA MOHAN

Dated: 21/10/2010

ORDER

C.N.RAMACHANDRAN NAIR &
K.SURENDRA MOHAN, JJ.

.....
I.T. Appeal Nos.467, 720, 730, 843, 479,
1324 & 1045 of 2009 & 40 of 2010
.....

Dated this the 21st day of October, 2010.

JUDGMENT

Ramachandran Nair, J.

The question raised in the 8 connected appeals, 7 filed by the Revenue and one by one of the Banks is one and the same i.e. whether proportionate disallowance of interest paid by the Bank is called for under Section 14A of the Income Tax Act (hereinafter called "the Act") for the investments made in U.T.I. shares, tax free bonds/securities etc. which yielded tax free dividend and interest. We have heard Senior counsel Sri.P.K.R.Menon appearing for the Revenue and Senior counsel Sri.Sarangan appearing along with Adv. Sri. P. Balakrishnan for the assessee-Banks.

2. The assesseees are all Scheduled Banks engaged in the banking business and in the course of banking business they are also engaged in the business of investment in bonds, securities and in shares which earn the assesseees interest from such securities and bonds and also dividend on investments in shares of companies and from units of U.T.I. etc., which are tax free. Section 14A was introduced to the Income Tax Act by Finance Act, 2001 with retrospective effect from 1.4.1962. This provision provide for disallowance of expenditure incurred by the assessee in relation to income which does not form part of the total income. In other words, if the assessee incurs any expenditure for earning tax free income such as interest paid for funds borrowed, for investment in any business which earns income that is free from tax, assessee is not entitled to deduction of such interest or other expenditure. Even though the provision was brought to the statute with retrospective effect from 1.4.1962, the retrospectivity is neutralised by a proviso later

introduced by Finance Act, 2002 with effect from 11.5.2001 whereunder reassessment, rectification of assessment etc. were prohibited for any assessment year beginning on or before 1st April, 2001. In other words, assessments for any assessment year upto the assessment year 2000-2001 that were finalised when the proviso was introduced without making any disallowance under Section 14A, were allowed to achieve finality. Disallowance under Section 14A was intended to be made only for pending assessments and for assessments for the assessment years commencing from 2001-2002 onwards. In all these cases disallowance made under Section 14A are either in pending assessments or for assessments for the assessment years commencing from 2001-2002 onwards. No dispute is raised by the assessee against application of Section 14A by virtue of operation of the proviso to the said Section introduced by Finance Act, 2002.

Admittedly none of the assessee-Banks have separate accounts for the investments made in bonds, securities and shares wherefrom tax free income is earned so that disallowance could be limited to the actual expenditure incurred. In other words, the assessee-Banks do not have separate accounts for the expenditure incurred towards interest paid on funds borrowed such as deposits utilised for investments in securities, bonds and shares which yielded tax free income. The position is same so far as the overhead and administrative expenditure of the assessee is concerned. In the absence of separate accounts for investments which earn tax free income, the Assessing Officer worked out a formula which is the average cost of deposit in the year under consideration and applying the same he made proportionate disallowance of interest attributable to the funds invested to earn tax free income. As a specimen case we extract hereunder actual figures available in the assessment of Catholic Syrian Bank Ltd. for the assessment year 2001-2002 (I.T.A. No.467/2009).

Net income from business as per return	- Rs.15,79,50,512/-
Interest from tax free bonds	- Rs.1,05,97,555/-
Tax free dividend	- Rs.1,42,27,983/-

What is clear from the above is that assessee has earned substantial tax free income by way of interest from tax free bonds and dividend income which is also tax free. So much so, substantial expenditure is incurred for earning the tax free income such as interest paid on borrowed funds (including deposits) utilised for investment and administrative expenditure for the same. Since actual expenditure incurred for earning the tax free income is not available for making disallowance under Section 14A, the Assessing Officer found out the average cost of deposit of the relevant year. Since the assessee's investment on tax free bonds and shares during the relevant year was Rs.13.06 crores, the Assessing Officer worked out 8.72% of this as the interest expenditure incurred by the assessee for earning tax free income. The disallowance was accordingly worked out at Rs.1,13,88,320/-. In other words, for earning a total tax free income under two heads of Rs.2,48,25,538/-, the Assessing Officer found that the assessee would have suffered an interest liability of Rs.1,13,88,320/- and, therefore, this amount was disallowed under Section 14A of the Act. Even though in the case of some of the assessee the Assessing Officer has even determined proportionate administrative cost and disallowed the same, in the case of this assessee for this assessment year we do not find any such disallowance.

In other words, disallowance under Section 14A is limited to interest alone. Since the issue raised has to be decided with reference to the scope of Section 14A, we extract hereunder the said Section with sub-clauses (2) and (3) and the proviso:

"S.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, 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."

It has to be noted that sub-sections (2) and (3) were introduced to the main Section by Finance Act, 2006 with effect from 1.4.2007.

Subsequently Rule 8D was prescribed by the Government for the purpose of sub-section(2) of Section 14A from 2007-2008 onwards.

By virtue of the subsequent legislation, now there is precise formula for working out the disallowance to be made under Section 14A even if assessee do not have separate account showing the expenditure incurred on investments made for earning tax free income.

3. The question, therefore, to be considered is whether Section 14A prior to the introduction of sub-sections (2) and (3) entitles the department to make disallowance of expenditure incurred for earning tax free income in cases where assessee like the Banks do not maintain separate accounts for the investments and other expenditure incurred for earning tax free income. Senior counsel appearing for the Revenue relied on our judgment in I.T.A. No.1784/2009 dated 14.6.2010 in the case of COMMISSIONER OF INCOME TAX VS. SMT.LEENA RAMACHANDRAN for the proposition that estimated disallowance under Section 14A is permissible. Another decision cited by the Revenue in support of their contention is the recent decision of the Supreme Court in COMMISSIONER OF INCOME TAX VS. WALFORTH SHARE AND STOCK BROKERS P. LTD. reported in (2010) 326 ITR 1. Both counsel appearing for assessee-Banks relied on decision of the Supreme Court in COMMISSIONER OF INCOME TAX VS. INDIAN BANK LTD. reported in (1965) LVI ITR 77 and contended that where separate accounts are not available with the Bank with regard to expenditure incurred on earning tax free income, there is no scope for disallowance under Section 14A at all. According to both counsel for the assessee proportionate disallowance is called for only under sub-section (2) read with Rule 8D of the Income Tax Rules which came into force from 2007-2008 onwards and the same cannot be applied for any earlier assessment year. We do not think much reliance can be placed on the decision of the Supreme Court in the case of INDIAN BANK LTD. because the said decision was rendered much prior to the introduction of Section 14A and the purpose of Section 14A itself is to get over judgments of the Supreme Court and High Courts declaring assessee's eligibility for deduction of business expenditure incurred for earning the income irrespective of whether such income is taxable or not. In our view, the object of Section 14A is to ensure that so much of the expenditure incurred for earning income that do not constitute total income of the assessee, should not be allowed. In other words, when income is outside the tax net, expenditure incurred for earning such income also should not be allowed to be set off in the computation of taxable income. Therefore, the short

question to be considered is whether non-maintenance of separate accounts by the assessee with regard to expenditure incurred for earning non-taxable income is justification for them to claim immunity from the operation of Section 14A. In fact, the subsequent legislation i.e. introduction of sub-section (2) and the prescription of Rule 8D thereunder, make it clear that there may be cases where it would be difficult for assessees to maintain separate accounts for earning taxable as well as non-taxable income. However, what we feel is that such difficulty may be experienced in the case of overhead expenditure and administrative expenditure incurred by the assessee-Banks. So far as investments in securities and bonds and also in shares, the income wherefrom is tax free are concerned, we see no reason why assessee could not have maintained separate accounts for the sources of funds utilised for such investments which, in our view, if the assessee-Banks wanted, they could have maintained. In other words, if the assessee-Banks had a case that surplus funds available or funds sourced other than through borrowing only were utilised for investing in securities, bonds and shares which yield tax free income, they could have maintained such accounts and produced the same before the Assessing Officer when proportionate disallowance was proposed by the Assessing Officer. By subsequent amendment through sub-section (2) and by prescribing Rule 8D therein what is achieved is prescribing specific guideline for disallowance in cases where separate accounts are not available on the expenditure incurred for earning tax free income. These are, therefore, only clarificatory provisions and in our view, the main clause of Section 14A apply for all periods after the introduction of the same in the statute which authorises the officer to make disallowance of the expenditure incurred for earning tax free income, irrespective of whether assessee maintained separate accounts or not. Considering the significant amount of tax free income earned by the assessee-Banks for all the years involved, we are of the view that the investments for earning tax free income is substantial and if assessment is made without making disallowance under Section 14A, the same will render a distorted figure of taxable income which is not permissible under the Act. If the assessee does not maintain separate accounts, it is for the Assessing Officer to estimate the same by adopting a rational basis. In principle, we, therefore, uphold the disallowance made by the Assessing Officer under Section 14A. We, therefore, uphold the order of the Tribunal impugned in I.T.A. No.40/2010 wherein they have followed a Special Bench decision of the Bombay Bench of the Tribunal in I.T.O. vs. DAGA CAPITAL MANAGEMENT PVT. LTD. reported in 312 ITR (AT) 1 (Mum.) (SB) and reverse the orders of the Tribunal and that of the first appellate authority in all other seven appeals.

4. The next question to be considered is whether the method adopted by the Assessing Officer in estimating average cost of deposit and making the disallowance by working out average interest cost on the investments made for earning the tax free income is correct. After hearing both sides, we feel the matter requires reconsideration because in the first place, facts and figures are not available. Further, the assumption of the Assessing Officer that the entire investments in bonds, shares and securities for earning tax free income is from out of borrowed funds (deposits) is also not justified. Assessee-Banks have a specific case that they have funds available with them which are neither borrowals nor interest bearing deposits and such funds also have been utilised in making investments for earning tax free income. We find force in this contention because when accounts are not available, the disallowance could be made only on the expenditure incurred for earning the tax free income which is to be estimated on a rational basis.

In fact, in our view, the Assessing Officer could have taken the following formula to arrive at the interest liability incurred by the assessee-Banks to earn interest free income:

$$\begin{array}{l} \text{Total interest liability} \\ \text{-----} \times \text{Tax free income earned by the assessee} \\ \text{Total income} \end{array}$$

5. What we have stated above is only a reasonable suggestion for the Assessing Officer to adopt which arises only if assessee is not able to establish more accurately the interest spent on earning tax free income. We, therefore, leave this matter to be decided by the Assessing Officer with reference to the accounts of the assessee-Banks for each year. Since we find that the rational adopted by the Assessing Officer to estimate the expenditure for the purpose of disallowance under Section 14A is not tenable, we feel the matter should be restored to the Assessing Officer for making disallowance under Section 14A by reasonably estimating as nearly as possible the expenditure incurred for earning the tax free income. This should be done after giving opportunity to the assessee-Banks to suggest their own formula with reference to accounts for the purpose of arriving at the actual amount or near actual amount. The disallowance on estimated basis has to be done as above until Rule 8D was framed and thereafter it is for the Assessing Officer to make disallowance by following sub-section (2) of Section 14A and Rule 8D of the Income Tax Rules.

6. So far as the disallowance of administrative expenditure is concerned, we feel considering the fact that there is no precise formula for proportionate disallowance, no disallowance is called for, for proportionate administrative cost attributable to earning of tax free income until Rule 8D came into force. We, therefore, dispose of the appeals by setting aside the orders of the Tribunal and that of the first appellate authority on this issue and remand all the assessments back to the Assessing Officer for reworking disallowance under Section 14A in the case of each assessee for each assessment year. The proportionate disallowance under Section 14A should be limited to only interest liability and not overheads or administrative expenditure; which should be considered for disallowance under Rule 8D from 2007-2008 onwards.

C.N.RAMACHANDRAN NAIR
Judge

K.SURENDRA MOHAN
Judge