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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**
19.
\+ **ITA 802/2015**

PR. COMMISSIONER OF INCOME TAX DELHI-2 ..... Appellant
Through: Mr. P. Roy Chaudhari, Senior Standing counsel with Ms. Lakshmi Gurung and Mr. Ishant Goswami, Advocates.

versus

BHARTI OVERSEAS PVT. LTD. ..... Respondent
Through: Mr.Arvind Kumar, Advocate.

CORAM:
JUSTICE S. MURALIDHAR
JUSTICE RAJIV SHAKDHER

O R D E R

% 17.12.2015

Dr. S. Muralidhar, J.:

1. This appeal by the Revenue under Section 260A of the Income Tax Act, 1961 ('Act') is directed against the order dated 23rd March 2015 passed by the Income Tax Appellate Tribunal ('ITAT') in ITA No. 460/Del/2013.

2. The question sought to be urged before this Court is whether the ITAT was correct in affirming the order of the Commissioner of Income Tax (A) ['CIT(A)'] which had confined the disallowance under Section 14A of the Act to Rs. 30,26,552 for the AY in question?

3. The incidental issue that is sought to be raised is whether the ITAT could

read down Rule 8D (2)(ii) of the Income Tax Rules 1962 ('Rules'), and whether that was beyond the jurisdiction of the ITAT?

4. The Assessee Company was incorporated on 21st November 2005 as a service sector company engaged in the promotion of international telecom business and insurance business. For the AY 2008-09, the Assessee filed its original return of income on 19th September 2008 declaring loss of Rs.16,07,22,655. The income was revised on 16th December 2009, at a loss of Rs. 13,93,37,943. The revision of the amount of loss was pursuant to the scheme of arrangement approved by the High Court with effect from 1st October 2007.

5. The return was picked up for scrutiny. It was observed by the Assessing Officer ('AO') that the Assessee had shown dividend income of Rs.89, 02,540 out of which Rs. 68, 44,790 was claimed as exempt under Section 10 (34) of the Act. The Assessee was asked to show cause why a disallowance under Section 14A of the Act read with Rule 8D should not be made for the expenditure incurred in relation to income not forming part of the total income. The authorised representative (AR) of the Assessee in response thereto submitted a letter dated 24th November 2010, stating that in terms of Note 4 of the computation of taxable income, a sum of Rs. 6,84,479 constituting 10% of the net exempted dividend income had already been disallowed on account of indirect expenditure incurred in earning such income. The AO was, however, of the view that all expenses connected with the exempt income have to be necessarily disallowed regardless of whether they were direct or indirect, fixed or variable, and managerial or financial.

The claim of the Assessee that it had incurred 10% of the exempt income as expenditure was rejected. The AO then re-worked the disallowance by taking into account the interest which was not directly attributable to any particular income/receipt into account. The disallowance was worked out at Rs. 2,85,86,881 and after adjusting the disallowance already made by the Assessee itself, the disallowance of Rs. 2,79,02,402 was added to the taxable income of the Assessee.

6. The Assessee then appealed to the CIT (A). It was contended by the Assessee that Rule 8D would apply only if the AO, having regard to the accounts of the Assessee of a previous year, was not satisfied with the correctness of the claim of expenditure made by the Assessee. According to the Assessee there was no such recording of satisfaction to justify the invoking of Rule 8D. It was pointed out that the AO had disallowed against exempt income of Rs. 68,44,790, a sum of Rs. 41,37,781 as expense attributable under Section 14A of the Act, and that this mismatch of the disallowance and non-taxable income indicated that it was unreal and had no nexus to the exempt income. It was submitted that "The application of Rule 8D should not be such that it becomes incongruent. It cannot disallow expenses which relate to taxable Income". Reliance was placed on the decisions of this Court in ***Maxopp Investment Ltd. v. CIT (2012) 347 ITR 272 (Del)*** and the Punjab & Haryana High Court in ***CIT v. Hero Cycles Ltd., 323 ITR 518 (P&.H).*** Reference was also made to the decision of the Bombay High Court in ***Godrej & Boyce Mfg. Co. Ltd. v. CIT, 328 ITR 81 (Mum)***.

7. The CIT(A) noted that indeed the AO had not recorded the reasons for rejecting the claim of the Assessee regarding disallowance 10% of the exempt income as expenditure. The CIT (A) proceeded to observe that during appeal proceedings, it was found that "actually the amount of interest attributable to the earning of dividend income should have been taken at proportion of Rs. 83 lacs for the purpose of applying Rule 8D and not Rs. 5,52,83,131 as adopted by the AO". The disallowance was therefore re-worked at Rs.37,11,031. After adjusting the sum offered by the Assessee, the disallowance was restricted to Rs.30, 26,552.

8. The Revenue went in appeal before the ITAT. Significantly, no cross objections were filed by the Assessee. Therefore the only question considered by the ITAT was whether the CIT (A) was justified in restricting the disallowance under Section 14A of the Act as noted hereinbefore. The ITAT referred to the decision of the Kolkatta Bench of the ITAT in ***ACIT v. Champion Commercial Co. Ltd., (2012) 139 ITD 108,*** which in turn referred to the decision of the Bombay High Court in ***Godrej & Boyce Mfg. Co. Ltd*** (*supra*) and held that for the purposes of Rule 8D (2) (ii), the amount of interest not attributable to the earning of any particular item of income, i.e., 'common interest expenses' that was required to be allocated would have to exclude both expenditures, i.e., interest attributable to tax exempt income as well as that attributable to taxable income. The ITAT observed that notwithstanding the rigid wording of Rule 8D (2), this interpretation was permissible in view of the stand taken by the Revenue before the Bombay High Court in ***Godrej & Boyce Mfg. Co. Ltd.*** (*supra*). The ITAT, therefore, was of the view that since there was no common

interest expenditure in the present case no portion of interest really survives for allocation under Rule 8D(2)(ii). Therefore the relief granted by the CIT (A) did not require interference. It was also noted that the Assessee did not file any appeal.

9. It is urged by Mr. P. Roy Chaudhary, learned Standing counsel for the Revenue, that the ITAT could not have read down Rule 8D (2)(ii) of the Rules as it was a Tribunal of limited jurisdiction. It is further submitted that the ITAT erred in ignoring the provisions of Rule 8D (2) (iii) thereby deleting the disallowance of Rs. 41,37,781 made by the AO under the said clause.

10. Mr. Arvind Kumar, learned counsel for the Assessee, submitted that on a collective reading of Section 14A of the Act and Rule 8D of the Rules, it is plain that if the variable 'A' under Rule 8D(2)(ii) is interpreted to include interest expense directly relatable to earning taxable income, then in effect it would result in disallowance of a certain portion of otherwise permissible deduction under the Act. This would be contrary to the very purpose and object of Section 14A of the Act. According to him if Rule 8 D (ii) is read with Section 14 A of the Act, then the only possible interpretation was that adopted by the ITAT. He further submitted that although the Assessee was not in appeal before the ITAT, or before this Court, he would still like to urge the issue concerning the AO not having recorded any satisfaction about untenablility of the claim of the Assessee as to what constituted the legitimate expenditure incurred for earning the exempt income.

11. As regards the last submission of learned counsel for the Assessee, this Court is not inclined to entertain such a plea. The fact of the matter is that the Assessee accepted the order of the CIT (A) limiting the disallowance and did not question it further before the ITAT.

12. The central issue that requires to be considered is whether the ITAT was justified in upholding the order of the CIT (A) by interpreting Rule 8D (2) (ii) of the Rules in the manner in which it has in the impugned order.

13. Section 14A (1) of the Act states that 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". Rule 8D of the Rules sets out the "method for determining amount of expenditure in relation to income which does not form part of income". Rule 8D reads as under:

> "**8D.** (1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with—
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> (*a*) the correctness of the claim of expenditure made by the assessee; or
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> (*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 amounts, namely
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> (*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 x 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 and 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 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.

(3) For the purposes 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."

14. As far as Rule 8D (2) (i) is concerned, the AO has necessarily to record that he is not satisfied with the correctness of the claim of the expenditure made by the Assessee in relation to the income which does not form part of the total income . That this requirement is mandatory is now well settled in view of the decision of this Court in ***Maxopp Investment*** (*supra*). For Rule 8 D (2) (ii) to apply there has to be some expenditure by way of interest

"which is not directly attributable to any particular income or receipt." If there is no such expenditure, as has been found factually by the ITAT in the present case, then the question of applying the formula thereunder will not arise.

15. Nevertheless, the ITAT has had to interpret Rule 8D (2) (ii) since the AO applied it and the CIT (A) had to decide whether that interpretation was correct. That is how this Court too is called upon to decide whether the ITAT was right in its interpretation of that provision. The methodology set out under Rule 8D for determining the amount of expenditure in relation to the exempt income corresponds to Section 14 A (2) of the Act. Section 14A (3) clarifies that Section 14A (2) would apply when the Assessee claims that no expenditure has been incurred in relation to the exempt income.

16. The object behind Section 14A (1) is to disallow only such expense which is relatable to tax exempt income and not expenditure in relation to any taxable income. This object behind Section 14A has to be kept in view while examining Rule 8D (2) (ii). In any event a rule can neither go beyond or restrict the scope of the statutory provision to which it relates.

17. Rule 8D (2) states that the expenditure in relation to income which is exempt shall be the aggregate of (i) the expenditure attributable to tax exempt income, (ii) and where there is common expenditure which cannot be attributed to either tax exempt income or taxable income then a sum arrived at by applying the formula set out thereunder. What the formula does is basically to "allocate" some part of the common expenditure for

disallowance by the proportion that average value of the investment from which the tax exempt income is earned bears to the average of the total assets. It acknowledges that funds are fungible and therefore it would otherwise be difficult to allocate the sum constituting borrowed funds used for making tax-free investments. Given that Rule 8 D (2) (ii) is concerned with only 'common interest expenditure' i.e. expenditure which cannot be attributable to earning either tax exempt income or taxable income, it is indeed incongruous that variable A in the formula will not also exclude interest relatable to taxable income. This is precisely what the ITAT has pointed out in ***Champion Commercial*** (*supra*). There the ITAT said that by not excluding expenditure directly relatable to taxable income, Rule 8D (2) (ii) ends up allocating "expenditure by way of interest, which is not directly attributable to any particular income or receipt, plus interest which is directly attributable to taxable income." This is contrary to the intention behind Rule 8D (2) (ii) read with Section 14A of (1) and (2) of the Act.

18. The following illustration provided by the ITAT in ***Champion Commercial*** (*supra*) demonstrates the incongruity:

> "In the case of A & Co. Ltd., total interest expenditure is Rs.1,00,000, out of which interest expenditure in respect of acquiring shares from which tax free dividend earned is Rs.10,000. Out of the balance Rs. 90,000, the assessee has paid interest of Rs. 80,000 for factory building construction which clearly relates to the taxable income. The interest expenditure which is "not directly attributable to any particular receipt or income" is thus only Rs. 10,000.
>
> However, in terms of the formula in Rule 8D(2) (ii), allocation of interest which is not directly attributable to any particular income or receipt will be for Rs.90,000 because, as per formula the value of

> A(i.e. such interest expenses to be allocated between tax exempt and taxable income) will be "A = amount of expenditure by way of interest other than the amount of interest included in clause (i) [i.e. direct interest expenses for tax exempt income] incurred during the previous year".
>
> Let us say the assets relating to taxable income and tax exempt income are in the ratio of 4:1. In such a case, the interest disallowable under Rule 8D(2) (ii) will be Rs.18,000 whereas entire common interest expenditure will only be Rs.10,000".

19. What the ITAT has done in the present case instead is to follow its earlier decision in ***Champion Commercial*** (*supra*) which in turn followed the decision of the Bombay High Court in ***Godrej & Boyce Mfg. Co. Ltd.*** (*supra*). The ITAT did not on its own read down rule 8D (2) (ii). Rather, it went by the stand taken by the Revenue before the Bombay High Court in ***Godrej & Boyce Mfg. Co. Ltd.*** (*supra*) in countering the challenge to the constitutional validity of Rule 8 D (2). The stand of the Revenue was that variable A in the formula in Rule 8D (2) (ii) would exclude both interest attributable tax exempt income as well as taxable income. The Bombay High Court took on board the said statement and negatived the challenge to the constitutional validity of the provision by holding as under:

> "60. In the affidavit-in-reply that has been filed on behalf of the Revenue an explanation has been provided of the rationale underlying Rule 8D. In the written submissions which have been filed by the Addl. Solicitor General it has been stated, with reference to R.8D(2) (ii) that since funds are fungible, it would be difficult to allocate the actual quantum of borrowed funds that have been used for making tax-free investments. It is only the interest on borrowed funds that would be apportioned and the amount of expenditure by way of interest that will be taken (as 'A' in the formula) will exclude any expenditure by way of interest which is directly attributable to any

> particular income or receipt (for example- any aspect of the assessee's business such as plant/machinery et.)….. The justification that has been offered in support of the rationale for R.8D cannot be regarded as being capricious, perverse or arbitrary. Applying the tests formulated by the Supreme Court it is not possible for this Court to hold that there is writ on the statute or on the subordinate legislation perversity, caprice or irrationality. There is certainly no 'madness in the method".

20. Therefore the Court is unable to agree with the Revenue that in adopting the above interpretation the ITAT has on its own read down Rule 8D (2) (ii) of the Rules and therefore travelled beyond the scope of its jurisdiction and powers.

21. In the case in hand, in Note 4 of the computation of income submitted by the Assessee, the total interest debited to the profit and loss account was Rs.5,52,83,131. There was an entry regarding interest on loans given to two entities. After accounting for the other interest expenditure, the Assessee computed the total interest expenditure which was allowable as Rs.83,90,178. In the computation drawn up by the Assessee, the entire interest expenditure was incurred for earning either taxable income or exempt income. There was no interest amount which was not directly attributable to either the tax exempt or taxable income. The ITAT, therefore, correctly observed in the present case "no portion of interest really survives for allocation under Rule 8D (2) (ii)". However, as rightly pointed out by the ITAT, since the Assessee did not challenge the order of the CIT (A) to the extent it restricted the disallowance, that part of the order of the CIT (A) remained.

22. The point concerning Rule 8D (2) (iii) does not appear to have been urged by the Revenue before the ITAT and therefore not considered by it. In any event that does not affect the interpretation of Rule 8D (2) (ii) which was the only issue considered by the ITAT in the impugned order.

23. For the aforementioned reasons, the impugned order of the ITAT does not call for any interference. No substantial question of law arises for consideration.

24. The appeal is dismissed.

S. MURALIDHAR, J

RAJIV SHAKDHER, J

DECEMBER 17, 2015
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