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

+ ITA 7/2019

THE PR. COMMISSIONER OF INCOME TAX -3 Appellant

Through: Mr. Ruchir Bhatia, Senior Standing
Counsel for Revenue.

versus

DECENT FINANCIALS SERVICES PVT. LTD. Respondent

Through: Mr. Ved Kumar Jain & Mr. Nishchay
Kantoor, Advocates.

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Date of Decision: 24th November, 2022

CORAM:

HON'BLE MR. JUSTICE MANMOHAN

HON'BLE MS. JUSTICE MANMEET PRITAM SINGH ARORA

J U D G M E N T

MANMEET PRITAM SINGH ARORA, J (ORAL):

1. The present appeal has been filed by the Revenue under Section 260A of the Income Tax Act, 1961, (the 'Act') against the order dated 5th July, 2018, passed by the Income Tax Appellate Tribunal ('ITAT') in ITA No. 594/Del/2016, for the Assessment Year ('AY') 2012-13.

2. The facts of the case relevant for deciding the present appeal are as follows:

2.1. The Respondent-Assessee, is engaged in the business of dealing of shares and securities. On 29th September, 2012, the Assessee filed its Income Tax Return ('ITR') declaring a loss of Rs. 4,86,38,974/-. The case of

the Assessee was selected for scrutiny assessment and notice under Section 143(2) of the Act was issued.

2.2. During the assessment proceedings, the Assessing Officer ('AO') noticed that, for the relevant previous year, the Assessee had earned a sum of Rs. 1.57 crore as dividend from the stock held as investment and the same has been claimed as exempt income. The AO issued a notice to the Assessee seeking an explanation as to why no disallowance should be made under Section 14A of the Act read with Rule 8D of the Income-tax Rules, 1962 (the 'Rule 8D').

2.2.1. For computing the taxable income, the Assessee had *suo moto* disallowed Rs. 1,19,592/- towards administrative expenditure, which included proportionate expenses of salary of staffs and other expenses. With respect to interest paid on the unsecured loan attributable to the investment, the Assessee stated that it has capitalized the interest with the investments, which was to the tune of Rs. 12.24 crores and has charged to the profit and loss account and a sum of Rs. 6.03 crores on account of interest. The Assessee, therefore, contended before the AO that Section 14A of the Act has no application and the formula of Rule 8D cannot be applied.

2.2.2. The AO held that the apportionment of direct or indirect expenditure towards taxable and exempt income has now become academic in view of Rule 8D, which prescribes the mechanism for working out the disallowance under Section 14A of the Act for exempt income earned by Assessee. The AO, accordingly, by applying the formula of Rule 8D(2)(ii) of the Income-tax Rules, 1962 (the 'Rule 8D(2)(ii)') determined a disallowance of Rs. 3,32,32,761/- on account of interest and by applying a formula of Rule 8D(2)(iii) of the Income-tax Rules, 1962 (the 'Rule 8D(2)(iii)') determined a

disallowance of Rs. 48,29,200/- towards administrative expenditure. The Assessee was, therefore, issued with the Assessment Order dated 12th February, 2015, resulting in an addition on account of disallowance of Rs. 3,80,61,962/- under Section 14A of the Act read with Rule 8D.

2.3. The Assessee filed an appeal against the assessment order before the Commissioner of Income Tax (Appeals) ['CIT(A)'] challenging the aforesaid addition under Section 14A of the Act. The CIT(A) partly allowed the appeal vide order dated 18th November, 2015, restricting the disallowance under Section 14A read with Rule 8D(iii) of the Income-tax Rules, 1962 (the 'Rule 8D(iii)') for administrative expenditure to Rs. 1,62,209/-. Pertinently, the CIT(A) deleted in entirety the disallowance made under Rule 8D(2)(ii) towards interest. The relevant portion of the order of the CIT(A) reads as follows:

“C. For the proposition that assessing officer has drawn an adverse inference, must record a reasonable satisfaction before disallowing the claim of the assessee (as per section 14A (2) of the Act)

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v. In the case of the appellant, the Assessing officer has invoked the provisions of section 14A of the Act, without complying with the essential requirements of section 14A. As already submitted above, since the Learned AO has failed to record any objective satisfaction with reference to the incorrectness of the claim of the appellant, having regard to the accounts of the appellant, the disallowance made under section 14A of the Act in the assessment order is against the provisions of section 14A of the Act.

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2.1 Having gone through the detailed submissions of the appellant, the order of assessment passed by the Assessing Officer and the material facts placed on the record, it emerges from the facts that the Assessing Officer has made the further disallowance of interest of Rs. 3,32,32,761/- under Rule 8D(ii) of the Income Tax Rules, The evidence adduced during the assessment as well as

appellate proceedings indicate that appellant has paid total interest of Rs. 18.27 crores and out of that interest of Rs. 12.24 crores has been capitalized to the investment portfolio. The Assessing Officer has further worked out the disallowance of interest of Rs. 3,32,32,761/- without giving any findings on this aspect. In view of the irrefutable facts on the record, the addition of Rs. 3,32,32,761/- u/s 14A read with Rule 8D(ii) of the Income Tax Rules made by the Assessing Officer is hereby deleted and the Assessing Officer is directed to modify the order of assessment accordingly.

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“4. Accordingly, I am of the considered view that appellant has incurred various indirect expenses for earning the exempt income and such expenses have been debited in the profit and loss account. There may not be a direct head relating to investment expenditure but all indirect expenses debited to profit and loss account indirectly relates to investment activities also. The Assessing Officer may not have given a finding in this regard but the powers of CIT(Appeal) are co-terminus with that of the Assessing Officer, therefore, I am satisfied that the appellant has incurred various indirect expenses on administration which are indirectly related to investment activities and earning of exempt income. The appellant has incurred administrative expenditure of Rs. 3,34,118. This expenditure contains the amount of Rs. 9,700 which has been expended on the travelling for the purpose of purchase and the sale of securities. The remaining expenditure of Rs. 3,24,418 is apportioned equally for the trading and investment activities. The disallowance of Rs. 48,29,200 made by the Assessing Officer is therefore, restricted to Rs. 1,62,209/- under Rule 8D(iii) read with Section 14A of the Act.”

(Emphasis supplied)

2.4. Aggrieved by the order dated 18th November, 2015, the Revenue preferred an appeal before the ITAT, whereby vide the impugned order, the appeal was dismissed. The ITAT noted that the Assessee had given a detailed explanation regarding the expenditure incurred and the manner in which the exempt income has been received, however, the AO proceeded with the disallowance without recording its satisfaction which is a mandatory requirement in terms of Section 14A(2) read with Rule 8D(1). The relevant portion of the impugned order reads as follows:

“4. After considering the rival submissions and on perusal of the relevant finding given in the impugned order as well as material referred to before us at the time of hearing, we find that before the Assessing Officer the assessee has given a very detailed explanation not only with regard to the nature of interest expenditure debited but also the details of administrative expenses incurred by the assessee and the manner in which the exempt income has been received by the assessee after placing the entire nature of accounts. The Assessing Officer without even examining the said accounts has proceeded to simply apply the formula laid down in Rule 8D without recording his ‘satisfaction’ which is mandatory requirements in terms of Section 142A(2) read with Rule 8D(1). Ld. CIT(A) has taken note of entire nature of expenditure debited, the amount of interest capitalized by the assessee and the nature of administrative expenditure debited and then has given a categorical finding that out of the administrative expenditure of Rs. 3,34,118/- only Rs. 1,62,209/- can at best be treated as expenditure attributable for earning of the exempt income. Moreover the assessee’s contention that it had huge surplus funds for making the investment has not been rebutted at any stage. Accordingly, the said finding of the CIT(A) is inconsonance with the conditions laid down in Rule 14A (2) and therefore, attribution of the expenditure by him is not only correct on faces but also in law, therefore, we do not find any infirmity in such order of the ld. CIT (A). Hence the same is hereby affirmed.”

(Emphasis supplied)

3. The learned counsel for the Appellant, Revenue, states that the ITAT erred in deleting the disallowance of Rs. 3,32,32,761/- made by the AO under Section 14A of the Act read with Rule 8D(2)(ii) and Rs. 46,66,991/- under Rule 8D(2)(iii). He states that the ITAT fell in error in not considering the circular of the Board No. 5/2014 dated 10th February, 2014, wherein it has been held that the disallowance of expenditure under Section 14A of the Act shall be made even in a year when the taxpayer has not earned any exempt income.
4. The learned counsel for the Respondent states that AO invoked the provisions of the Section 14A of the Act without recording any objective satisfaction with respect to the incorrectness of the explanation of the

Assessee for the expenditure incurred and *suo moto* disallowed by the Assessee. He states that on this ground alone the disallowance made under Section 14A of the Act is incorrect.

5. He states that without prejudice to the above in the facts of this case, the Assessee had made payment of Rs. 18,26,65,176/- towards interest availed on loans. However, the Assessee had capitalized Rs. 12,23,74,218/- to cost of investment and not claimed the same as expenses in its profit and loss account. He states that the AO despite duly noting and confirming the said fact from the Assessee's accounts erred in applying Rule 8D(2)(ii) for making a further disallowance of Rs. 3,32,32,761/- and therefore, the appellate authorities have correctly deleted the said disallowance.

6. He further, states that with regard to administrative expenditure, the total expenses incurred by the Assessee during the relevant previous year was Rs. 3,34,118/- and therefore, the disallowance of Rs. 48,29,200/- is untenable. He states that the Assessee had duly apportioned a sum of Rs. 1,19,592/- as administrative expenditure towards the exempt income and therefore, the ITAT has rightly deleted the disallowance made under Rule 8D(2)(iii). He states that in the facts of this case, the *suo moto* disallowance made by the Assessee on account of interest and administrative expenditure is far in excess of the exempt dividend income of Rs. 1.57 crores.

7. We have heard the learned counsel for the parties and perused the paper-book. The appellate authorities have returned a concurrent finding that the AO, without examining the accounts of the Assessee, mechanically proceeded to apply the formula laid down in Rule 8D.

8. The assessment order records that the Assessee filed a detailed reply dated 16th December, 2014, and an additional reply dated 16th January,

2015, explaining the *suo moto* disallowance made by the Assessee on account of interest and administrative expenditure. In its explanation, the Assessee categorically asserted that it has capitalised interest expenditure of Rs. 12.24 crores to its investment and not claimed the same as its business expense. The Assessee also clarified that proportionate administrative expenditure of Rs. 1.19 lakhs has been disallowed and not debited to the profit and loss account. A perusal of the assessment order reveals that the AO without recording his dissatisfaction with the explanation offered by the Assessee proceeded to apply the formula of Rule 8D perfunctorily. The relevant portion of AO's order reads as follows:

“6. In reply of above Show Cause Notice, the assessee submitted its reply vide letter dated 16.01.2015 and made the following submissions; -

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The reply of the assessee have been considered it is seen that out of the interest payment of Rs. 18,26,65,176/- the company has capitalized Rs. 12,23,74,218/- to the cost of investment and not-claimed the same as expenses in the Profit and Loss Account.

7. However, in view of the Supreme Court judgment in the case of CIT Vs United General Trust Ltd 200 ITR 455 (SC) coupled with the finding that expenditure has been incurred by the assessee Company on the earning of the dividend income and in absence of any better method, suggested by Rule 8D of the income Tax Rules is adopted in determining the expenditure incurred by the assessee company in relation to dividend income/ exempt income, which is not includible in the total income.”

9. Pertinently, the AO after examination of the accounts of the Assessee was convinced that the Assessee has capitalised the interest expenditure of Rs. 12.24 crores to the cost of investment and not debited the same to the profit and loss account. The AO, has also not made any adverse observation

with respect to the Assessee's disallowance for administrative expenditure of Rs. 1.19 lakhs. However, without expressing any dissatisfaction with the aforesaid disallowances made by the Assessee, which is a mandatory requirement of Section 14A(2) read with Rule 8D(1), the AO on an erroneous understanding of law observed that disallowance of expenditure with has to be made mechanically, in each case where exempt income is earned, as per the fixed formula of Rule 8D.

10. We are of the considered view that the AO had misdirected himself in law by holding as above. The formula under Rule 8D(2) can be applied by the AO only if he is dissatisfied with the explanation offered by the Assessee with respect to the expenditure incurred for earning exempt income. There cannot be a default application of Rule 8D in every case where the Assessee has earned exempt income. The Rule can have application only where the working of the assessee has not been found to be satisfactory as held in *Income Tax-VI Vs. Taikisha Engineering India Ltd., 2014 SCC Online Del 7156* at para 20 which reads as under:

"20. However, in the present case we need not refer to sub Rule (2) to Rule 8D of the Rules as conditions mentioned in sub Section (2) to Section 14A of the Act read with sub Rule (1) to Rule 8D of the Rules were not satisfied and the Assessing Officer erred in invoking sub Rule (2), without elucidating and explaining why the voluntary disallowance made by the assessee was unreasonable and unsatisfactory. We do not find any such satisfaction recorded in the present case by the Assessing Officer, before he invoked sub Rule (2) to Rule 8D of the Rules and made the re-computation. Therefore, the respondent assessee would succeed and the appeal should be dismissed."

In the facts of the present case as well, the AO without recording any dissatisfaction with respect to the expenditure disallowed by the Assessee proceeded to invoke the provisions of Section 14A of the Act erroneously and therefore, there is no infirmity in the finding of the ITAT.

11. The order of the AO suffers from another anomaly as it is contrary to the judgment of this Court in *Joint Investments Pvt. Ltd. v. Commissioner of Income Tax, [2015] 372 ITR 694* which lays down the principle that disallowance of expenditure cannot exceed the total exempt income earned. The Assessee has earned dividend income of Rs. 1.57 crores and it has disallowed interest expenditure of Rs. 12.24 crores and administrative expenditure Rs. 48,29,200/- which is far in excess of the exempt income earned. The AO by making a further disallowance of Rs. 3,80,61,962/- is acting contrary to the said principle of law. For this additional reason, in view of the judgment of this Court, no further disallowance could have been made by the AO. In order dated 25th February, 2015 in *Joint Investments Pvt. Ltd. (supra)* it was held as follows:

“9. In the present case, the AO has not firstly disclosed why the appellant/assessee's claim for attributing Rs. 2,97,440/- as a disallowance under Section 14A had to be rejected. Taikisha says that the jurisdiction to proceed further and determine amounts is derived after examination of the accounts and rejection if any of the assessee's claim or explanation. The second aspect is there appears to have been no scrutiny of the accounts by the AO - an aspect which is completely unnoticed by the CIT (A) and the ITAT. The third, and in the opinion of this court, important anomaly which we cannot be unmindful is that whereas the entire tax exempt income is Rs. 48,90,000/-, the disallowance ultimately directed works out to nearly 110% of that sum, i.e., Rs. 52,56,197/-. By no stretch of imagination can Section 14A or Rule 8D be interpreted so as to mean that the entire tax exempt income is to be disallowed. The window for disallowance is indicated in Section 14A, and is only to the extent of disallowing expenditure “incurred by the assessee in relation to the tax exempt income”. This proportion or portion of the tax exempt income surely cannot swallow the entire amount as has happened in this case.”

(Emphasis supplied)

12. The contention of the learned counsel for the Revenue with respect to the CBDT Circular No. 5/2014 is untenable in law as this Court in *Cargo Motors Pvt. Ltd. v. Deputy Commissioner of Income Tax, ITA No. 7/2020*

decided on 7th October, 2022 has held that the said circular cannot override the express provisions of the Section 14A of the Act. However, in the facts of the present case, since the Assessee has itself disallowed interest and administrative expenditure, which has not been doubted by the AO, the reliance placed on the circular is misplaced.

13. We are of the considered view that the facts and law have been correctly assessed by the ITAT and no substantial question of law arises for consideration in the present appeal and accordingly the same is dismissed.

MANMEET PRITAM SINGH ARORA, J

MANMOHAN, J

NOVEMBER 24, 2022

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