IN THE INCOME TAX APPELLATE TRIBUNAL,
KOLKATA 'B' BENCH, KOLKATA

[Coram: Pramod Kumar AM and Mahavir Singh JM]

I.T.A. No.: 644/ Kol. / 2012
Assessment year: 2008-09

Assistant Commissioner of Income Tax
Circle 10, Kolkata ***……..…..….Appellant***

Vs.

Champion Commercial Co Ltd ***……Respondent***
P 15, New CIT Road, Kolkata 700 073
[PAN : AABCC2373G]

CO No 55/Kol/2012
Arising out of I.T.A. No.: 644/ Kol. / 2012
Assessment year: 2008-09

Champion Commercial Co Ltd ***……Cross objector***
P 15, New CIT Road, Kolkata 700 073
[PAN : AABCC2373G]

Vs.

Assistant Commissioner of Income Tax
Circle 10, Kolkata ***……Respondent***

Appearances:
Asit Mahapatra and Susanta Kumar Saha, *for the revenue*
Manoj Kataruka, *for the assessee*

Date of concluding the hearing : September 19, 2012
Date of pronouncing the order : September 21, 2012

ORDER

Per Pramod Kumar:

1. The appeal filed by the Assessing Officer, as also cross objection filed by the assessee, call into question correctness of order dated 3rd January 2012 passed by the CIT(A) in the matter of assessment under section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), for the assessment year 2008-09. Grievances raised by both the parties, being interconnected and relating to scope of disallowance under section 14 A, are being taken up together. These grievances are reproduced below for ready reference:

Grievance of the Assessing Officer in appeal:
Whether, on the facts and in the circumstances of the case, the learned CIT(A) is justified in restricting the disallowance of Rs 30,81,503 under section 14 A, to Rs 3,71,687, by not applying the formula as per Rule 8 D correctly as applied by the Assessing Officer?

Grievances of the assessee in cross objection:
1. That on the facts and in the circumstances of the case, the action of the learned CIT(A) to confirm addition of Rs 3,71,687 under section 14A read with rule 8 D is bad in law.

2. That on the facts and in the circumstances of the case and material evidences on record, the action of the learned CIT(A) to make addition of Rs 3,71,687 under section 14A, read with Rule 8D, even after finding that there is no proximate link of expenditure with exempt income and further there was no satisfaction recorded by the Assessing Officer is erroneous, unjustified and excessive.

2. The material facts are not in dispute. The assessee is engaged in the business of trading in chemicals and dyes. In the course of scrutiny assessment proceedings, the Assessing Officer noticed that the assessee has earned tax exempt dividend income of Rs 6,63,033 but the assessee has not income any of the related expenditure for disallowance under section 14 A. It was explained by the assessee (i) that the assessee's entire turnover of around Rs 35 crores is in respect of chemicals and dyes and that there has been no trading of shares at all; (ii) that the assessee's own capital is of Rs 8.09 crores (borrowings are to the tune of Rs 4.05 crores) while assessee's total investment in shares is only Rs 5.40 crores, which shows that assessee's entire investment in the shares is out of own interest free capital; (iii) that the assessee has paid interest of Rs around Rs 41 lakhs on the borrowings whereas assessee's interest income is of Rs 2.20 lakhs; (iv) that the provisions of Section 14 A cannot be invoked on the facts of the present case as there are "no expenses directly relatable to earning of exempt income and there is no expenditure incurred in relation to earning of exempt income of Rs 6,63,033" and as "the dividend income is directly debited to assessee's bank account for which no expenditure is required to be incurred"; (v) that the provisions of Section 14A read with Rule 8 D can only be invoked when there is actually an expenditure in relation to exempt income; and (vi)

that the stand of the assessee is supported by Hon'ble Punjab & Haryana High Court's judgment in the case of CIT Vs Hero Cycles (323 ITR 518) wherein Their Lordships have inter alia observed that "disallowance under section 14A requires a finding of incurring of expenditure" and "if it is found that, for earning the exempt income, no expenditure has been incurred, disallowance under section 14 A cannot stand". None of these submissions impressed the Assessing Officer. The Assessing Officer rejected these submissions, relying upon Special Bench decision of this Tribunal in the case of ITO Vs Daga Capital Management Pvt Ltd (117 ITD SB 169), and proceeded to make the disallowance as follows:

8(2)(i)	Demat Charges[1]	Rs 15,796
8(2)(ii)	$\frac{41,82,248^{2} \times 3,51,71,541^{3}}{5,09,25,290^{4}}$	Rs 28,89,850
8D(2)(ii)	0.5% of $\frac{5,41,47,604^{5}+1,61,95,478^{6}}{2}$	Rs 1,75,857
Total disallowance under section 14 A r.w.r 8 D		***Rs 30,81,503***

3. Aggrieved by the disallowance so made by the Assessing Officer, assessee carried the matter in appeal before the learned CIT(A). While learned CIT(A) apparently made observations to the effect that all the above contentions of the assessee are correct, in the concluding operative portion of the order, he recomputed the disallowance under section 14 A r.w.r. 6D as follows:

8(2)(i)	Demat Charges	Rs 15,796
8(2)(ii)	$\frac{5,41,313 \times 3,51,71,541}{5,09,25,290}$	Rs 1,80,034
8D(2)(ii)	0.5% of $\frac{5,41,47,604+1,61,95,478}{2}$	Rs 1,75,857
Total disallowance under section 14 A r.w.r 8 D		Rs 3,71,687

4. None of the parties is satisfied by the stand so taken by the learned CIT(A), and the Assessing Officer is in appeal, and the assessee in related cross

[1] Amount of expenditure directly relating to the income which is exempt from tax
[2] Amount of interest paid in the relevant previous year, other than interest included in 1 above
[3] Amount of average value of investments on which tax exempt income is earned
[4] Average value of total assets in the beginning and end of the previous year
[5] Value of investment, from which tax exempt income is earned, in beginning of the previous year
[6] Value of investment, from which tax exempt income is earned, at the end of the previous year

objection, before us. While Assessing Officer is aggrieved of the disallowance being restricted to Rs 3,71,7867, as against disallowance of Rs 30,81,503 made in the assessment proceedings, grievance of the assessee is that the disallowance should have been deleted in entirety. That is how we have come to be *in seisin* of the matter.

5. We have heard the rival contentions, perused the material on record and duly considered factual matrix of the case as also the applicable legal position.

6. Let us take up assessee's grievance first, as it challenges the very application of Section 14 A to the facts of the case before us, because the Assessing Officer has not recorded a specific satisfaction to the effect that claim of the assessee, i.e. no expenditure is incurred on earning the tax exempt dividend, is incorrect. We see no substance in this plea. We dind that section 14 A (2) provides that, "(t)he 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" and section 10 A (3) provides that, "(t)he 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". While a lot of emphasis is placed by the learned counsel on wordings of Section 14A(2) which refer to the need of Assessing Officer's satisfaction to the effect that the claim made by the assessee is incorrect, it simply overlooks the provisions of Section 14A (3) which state that a disallowance under section 14A(2) can also be made in a case in which assessee claims that no expenditure has been incurred for earning the tax exempt income. Therefore, a plain reading of the statutory provisions of Section 14A(2) and (3) shows that when assessee offers a disallowance under section 14A, the provisions of Section 14A(2) read with rule 8 D cannot be invoked unless the Assessing Officer is satisfied about

incorrectness of the disallowance so offered, but when assessee does not offer any disallowance under section 14 A on his own, the provisions of section 14A(2) read with rule 8 D can be invoked without there being any need to express satisfaction about incorrectness of such a claim. That apart, as learned Commissioner (DR) Shri Mahapatra rightly points out, when assessee is paying interest on borrowings and the assessee is not able to show that investment in shares are out of internal accruals or non interest bearing funds, and in the light of by Hon'ble jurisdictional High Court in the case of Dhanuka & Sons Vs CIT (339 ITR 319), disallowance under section 14 A can indeed be made. In Dhanuka's case *(supra*), Their Lordships have, inter alia, observed as follows:

> *9. In the case before us, there is no dispute that part of the income of the assessee from its business is from dividend which is exempt from tax whereas the assessee was unable to produce any material before the authorities below showing the source from which such shares were acquired……*
>
> *10. In our opinion, the mere fact that those shares were old ones and not acquired recently is immaterial. It is for the assessee to show the source of acquisition of those shares by production of materials that those were acquired from the funds available in the hands of the assessee at the relevant point of time without taking benefit of any loan. If those shares were purchased from the amount taken in loan, even for instance, five or ten years ago, it is for the assessee to show by the production of documentary evidence that such loaned amount had already been paid back and for the relevant assessment year, no interest is payable by the assessee for acquiring those old shares. In the absence of any such materials placed by the assessee, in our opinion, the authorities below rightly held that proportionate amount should be disallowed having regard to the total income and the income from the exempt source. In the absence of any material disclosing the source of acquisition of shares which is within the special knowledge of the assessee, the assessing authority took a most reasonable approach in assessment.*

7. In the light of the views so expressed by Hon'ble jurisdictional High Court, we hold that the provisions of Section 14 A r.w.r. 8 D were rightly invoked on the facts of this case. As the views of Hon'ble jurisdictional High Court legally bind us, see no need to deal with the judgments of Hon'ble non jurisdictional High Courts and coordinate benches of this Tribunal, as cited before us. Suffice to reiterate that in any event, in a situation in which assessee

does not offer any disallowance under section 14A in respect of a tax exempt income, the provisions of Section 14A(2) read with rule 8 D can be invoked under section 14A(3). None of the judicial precedents cited before us anyway deal with this scenario, which is applicable on the facts of this case.

8. The plea raised in the cross objection is thus stands rejected.

9. The next issue is whether the computation of disallowance, as reworked by the learned CIT(A), is correct. On the face of it, based on a plain reading of rule 8 D, the computation of disallowance may be viewed incorrect inasmuch as one of the variables in formula sect out in rule 8 D (2)(ii) seems to have been wrongly adopted as 'interest paid in the relevant previous year which cannot be directly related to any of the asset' in the place of 'amount of interest paid in the relevant previous year, other than interest included in direct expenses incurred for earning tax exempt income', but, for the reasons we will now set out, in our considered view, this action of the CIT(A) is, even if somewhat serendipitously, in accordance with the correct legal position.

10. We find that in terms of the provisions of section 14 A (2), "(t)he 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…" and rule 8 D prescribes this method as follows:

> **Method for determining amount of expenditure in relation to income not includible in total income.—**
>
> (1) ……..
>
> (2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely :—
>
> (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 :-

$$A \quad \mathbf{X} \quad \frac{B}{C}$$

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.

11. There is no dispute about working of this method so far as rule 8D(2)(i) and (iii) is concerned. It is only with regard to the computation under rule 8D(2)(ii) that the Assessing Officer and the CIT(A) have different approaches. This provision admittedly deals with a situation in which "the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt". Clearly, therefore, this sub clause seeks to allocate 'common interest expenses' to taxable income and tax exempt income. In other words, going by the plain wordings of rule 8D(2)(ii) what is sought to be allocated is "expenditure by way of interest…….which is not directly attributable to any particular income or receipt" and the only categories of income and receipt, so far as scheme of rule 8 D is concerned, are mutually exclusive categories of 'tax exempt income and receipt' and 'taxable income and receipt'. No other classification is germane to the context in which rule 8 D is set out, nor does the scheme of Section 14 A leave any ambiguity about it.

12. Ironically, however, the definition of variable 'A' embedded in formula under rule 8D(2)(ii) is clearly incongruous inasmuch while it specifically excludes interest expenditure directly related to tax exempt income, it does not exclude interest expenditure directly related to taxable income. Resultantly, while rule 8D(2)(ii) admittedly seeks to allocate "expenditure by way of interest, which is not directly attributable to any particular income or receipt" it 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" *(emphasis by underlining supplied by us)*. This incongruity will be more glaring with the help of following simple example:

> 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 8 D (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 8 D(2)(ii) will be Rs 18,000 whereas entire common interest expenditure will only be Rs 10,000.

13. The incongruity arises because, as the wordings of rule 8D(2)(ii) exist, out of total interest expenses, interest expenses directly relatable to tax exempt income are excluded, interest expenses directly relatable to taxable income, even if any, are not excluded.

14. The question then arises whether we can tinker with the formula prescribed under rule 8D(2)(ii) of the Income Tax Rules, or construe it any other manner other than what is supported by plain words of the rule 8 D (2)(ii).

15. We find that notwithstanding the rigid words of Rule 8D(2)(ii), the stand taken by the revenue authorities about its application, as was before Hon'ble Bombay High Court in the case of Godrej & Boyce Mfg Co Ltd Vs DCIT (328 ITR 81) when constitutional validity of rule 8 D was in challenge, is that ***" 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 etc.)". Therefore, it is not only the interest directly attributable to tax exempt income, i.e. under rule 6D(2)(i), but also interest directly relatable to taxable income, which is to be excluded from the definition of variable 'A' in formula as per rule 6D(2)(ii), and rightly so, because it is only then that common interest expenses, which are to be allocated as indirectly relatable to taxable income and tax exempt income, can be computed. This is clear from the following observations made by Their Lordships of Hon'ble Bombay High Court in the case of Godrej & Boyce *(supra)*:

> **60. In the affidavit-in-reply that has been filed on behalf of the Revenue an explanation has been provided of the rationale underlying r. 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 etc.)…… 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'.**

16. Once the revenue authorities have taken a particular stand about the applicability of formula set out in rule 8 D(2)(ii), and based on such a stand constitutional validity is upheld by Hon'ble High Court, it cannot be open to revenue authorities to take any other stand on the issue with regard to the actual implementation of the formula in the case of any assessee. Viewed thus, the correct application of the formula set out in rule 8D(2)(ii) is that, as has been noted by Hon'ble Bombay High Court in the case of Godrej and Boyce *(supra)*, "**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 etc.)". Accordingly, even by revenue's own admission, interest expenses directly attributable to tax exempt income as also directly attributable to taxable income, are required to be excluded from computation of common interest expenses to be allocated under rule 8D(2)(ii).

17. To the above extent, therefore, we have to proceed on the basis that rigour of rule 8 D (2)(ii) is relaxed in actual implementation, and revenue authorities, having taken that stand when constitutional validity of rule 8 D was in challenge before Hon'ble High Court, cannot now decline the same. Ideally, it is for the Central Board of Direct Taxes to make the position clear one way or the other either by initiating suitable amendment to rule 8D(2)(ii) or by adopting an interpretation as per plain words of the said rule, but even on the face of things as they are at present , in our humble understanding, revenue authorities cannot take one stand when demonstrating lack of 'perversity, caprice or irrationality' in rule 8D before Hon'ble High Court, and take another stand when it comes to actual implementation of the rule in real life situations. Therefore, even as we are alive to the fact that the stand of the learned Departmental Representative is in accordance with the strict wording of rule 8D(2)(ii), we have to hold that, for the reasons set out above, this rigid stand cannot be applied in practice.

18. Coming to the facts of this case, we find that learned CIT(A) has not given categorical findings in respect of factual aspects of specific utilization of borrowings on which interest was paid, and he has simply accepted the assessee's contention that out of a total interest expenditure of Rs 41,84,249, a sum of Rs 36,42,935 was paid with respect to borrowing for the purposes of trading in chemicals, and the common interest expenses to be allocated was thus only Rs 5,41,313. Neither these details were before the Assessing Officer, nor has the CIT(A) sought any remand report on the same.

19. In our considered view, therefore, the right course of action will be that while we uphold the action of the CIT(A) in principle, assuming that it was

based on principle discussed earlier in this order that quantum of allocated common interest expenses were reduced, we remit the matter to the file of the Assessing Officer for adjudication *de novo* in the light of the legal position discussed above. We make it clear that common interest expenses which are to be allocated in terms of the formula under rule 8D(2)(ii) will only be such interest expenses as are neither directly attributable to borrowings specifically used for tax exempt incomes or receipts, nor are directly attributable to borrowings specifically used for taxable incomes or receipts. With these directions, the matter stands restored to the file of the Assessing Officer.

20. The plea raised by the Assessing Officer is thus rejected in principle but the matter is remitted to the file of the Assessing Officer for verification of factual elements in the terms indicated above.

21. To sum, while appeal of the revenue is allowed for statistical purposes in the terms indicated in this order, the cross objection of the assessee is dismissed. Pronounced in the open court today on 21st day of September, 2012.

Sd/xx ***Sd/xx***
Mahavir Singh **Pramod Kumar**
(Judicial Member) (Accountant Member)
Kolkata; September 21 , 2012.

* Laha Sr PS *
Copies to : *(1) The appellant*
(2) The respondent
(3) CIT
(4) CIT(A)
(5) The Departmental Representative
(6) Guard File

By order etc

Assistant Registrar
Income Tax Appellate Tribunal
Kolkata benches, Kolkata