IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI BENCHES, 'G ', MUMBAI

BEFORE SHRI, R.K.PANDA, ACCOUNTANT MEMBER AND SHRI VIJAY PAL RAO, JUDICIAL MEMBER

ITA No. 456 /Mum/2009
(Assessment Year :2004 -05)

Yatish Trading Co.P ltd,
4th fl,, Sadhana House, 570,
Pandurang Bhudhkar marg,
Worli,
Mumbai-400018
PAN: AAACY0189P ...Appellant

Vs

ACIT 1(3),
Mumbai ... Respondent

Assessee by : S/Shri S C Tiwari and Meghna Butala
Respondent by : Shri S K Patwa

O R D E R

PER VIJAY PAL RAO,JM

This appeal by the assessee is directed against the order dated 23.1.2007 of the learned CIT(A)-XXI for the assessment year 2004-05.

2. The assessee has raised various grounds in this appeal, however, the only issue arises for our consideration and adjudication is whether the learned CIT(A) is justified in directing the AO to re-compute the disallowance u/s 14A by applying the provisions of Rule 8D of Income Tax Rules, 1962.

3. There is a delay of 67 days in filing the appeal. The assessee has filed a petition for condonation of delay in the shape of affidavit .

4. We have heard both the parties and considered the relevant record. The assessee has explained the reasons for not filing the appeal within the time period of limitation that one of the directors Mr. Nakul Jagjivan who is key managerial person. Being NRI, his presence in the country is occasional based on work priorities. Before filing the appeal, the impugned order of the CIT(A) was to be examined, analyzed and required to be discussed with the said Director Mr. Nakul Jaggin who is staying abroad. Thus, the delay has been occurred due to the reason of non availability of one of the directors which is a bonafide, non intentional or not deliberate. It has been prayed that the delay of 67 days in filing the appeal may be condoned.

5. On the other hand, the learned DR has vehemently opposed the condonation of delay.

6. After considering the relevant record, facts and circumstance of the case as well as the reasons explained by

the assessee, we find that the assessee has explained the sufficient reasons for non-filing of the appeal within time.

7. It is settled law that while condoning the delay, the court should take a lenient view. It is always a question whether the explanation and reasons for delay was bonafide or was merely devise to cover an ulterior purpose such as laches on the part of the litigant or an attempt to save limitation in an underhand way. When it is found on record that the party has not acted in malafide but the reasons explained are factually correct then Court should be liberal in construing the sufficient cause and should lean in favour of such party. Whenever substantial justice and technical consideration are opposed to each other, cause of substantial justice has to be preferred. Justice oriented approach has to be taken by a court while deciding the matter for condonation of delay. However, this does not mean that a litigant gets free licence to approach the court at it's will. In view of this legal and factual position, we condone the delay of 67 days in filing the appeal before the Tribunal and take up the matter for adjudication on merits.

Disallowance u/s 14A of the IT Act.

8. The brief facts of the case are that the assessee company is engaged in the business of trading in shares and securities as well as in private projects and investment in shares and securities. During the previous year relevant to the assessment year under consideration the assessee earned dividend income of Rs. 2,98,92,569/- ;and claimed exemption under section 10(33) of the IT Act. During the relevant period the total income credited by the assessee to the profit and loss account amounting to Rs..39,03,43,325/- which includes dividend income of Rs.2,98,92,569/-. The assessee also debited an amount of Rs.10,68,26,946/- to the profit and loss account which includes administrative and other expenses of Rs.1,53,19,834/- and financial expenses of RS.`.6,36,05,264. The details of financial expenses are as under :

a) interest paid to Bank Others	Rs.63,33,224 Rs.5,38,55,863
Total	Rs 6,01,89,088
b) financial charges etc	Rs.34,16,176
	Rs 6,36,05,264

9. During the course of assessment proceedings, the AO called upon the assessee to explain as to why the proportionate expenses claimed in the profit and loss account relating to dividend income, which was not forming the part of the total income should not be disallowed u/s 14A of the Act.

10. In reply to the show cause notice of the AO, the assessee vide letter dated 27.10.2006, has submitted before the AO that the question of expenditure for earning the dividend income does not arise as there is a D-Mat Account and as such the assessee-company is receiving dividend by directly crediting in the D-Mat account. Thus, the assessee submitted that there is no question of incurring any expenditure on earning of the dividend income as the same is directly credited in the D-mat account. The assessee also submitted that assessee's share holder's funds are Rs.27,94,34,833.43 while the investment, at the most is Rs.27,06,64,720.10 which is less than the share holder's funds. Therefore, there is no question of disallowance of interest since the investment has been made out of the share holder's funds. The assessee further submitted that the assessee's is also dealing in trading in share business and in the year under consideration the assessee has shown the income in the share business to the extent of Rs .34,43,57,863.70. On the basis of this contention, the

assessee submitted that since assessee is dealing in trading in shares, the question of disallowance of interest does not arise. The assessee submitted that if there is any money borrowed for the business purposes, the same has to be allowed u/s 36(1)(iii) of the Act.

11. The AO, after going through the above submissions of the assessee vide letter dated 27.10.2006 again called upon the assessee to produce the details of utilization of borrowed funds with supporting evidence on which interest has been paid and debited to the profit and loss account.

12 Again, in reply to the above query of the AO, the assessee vide letter dated 31.10.2006 submitted that in view of the decision of the jurisdictional High Court in the case of CIT v/s Emraid Co.ltd (284 ITR 586) the interest paid on borrowed fund is allowable under section 36(1)(iii) as the same was for earning the business. On the basis of the decision of the jurisdictional High Court in the case of CIT V/s Emrald Co. Ltd(supra) it was submitted that the assessee is trading in shares, therefore, the question of applicability of section 14A does not arise as the monies have been borrowed only for the purposes of trading in shares. The assessee further submitted that in view of the decision of the jurisdictional High Court the client of the assessee is entitled to get the deduction of interest paid for doing the trading of the business in shares.

13. After going through the contents of the letter dated 31.10.2006, the AO was of the opinion that the assessee has quoted the observations of the decision of jurisdictional High Court in the case of CIT V/s Emraild Co. Ltd- and stated that the provision of the section 14A does not apply to the assessee. The AO observed that the assessee did not produced details of utilization of borrowed amount with supporting evidence on which the interest is paid and debited to the profit and loss account.

14. During the course of assessment proceedings the assessee submitted that the assessee has reduced the loan by Rs.1,28,58,678 i.e. the share holder's funds are Rs.27,94,34,833 and the investment is Rs..27,06,64,720/-. Therefore, the contention of the assessee was that the investment has been made only to the extent of their own funds, thereby assessee reduced the loan by Rs.1,28,68,678/-. The assessee further submitted that it has redeemed the preference shares to the tune of Rs .6 crores. The assessee by giving reference of balance sheet of their client submitted that on 31st March 2003, the share capital was Rs.15,00,00,000/- whereas balance sheet as on 31st March 2004 shows the capital at Rs 9,00,00,000/- which shows that the assessee has redeemed the preference shares of Rs..6,00,00,000/- This shows the reduction in capital to that

extent. In view of this factual position, the assessee submitted that it has not only paid the loan but also redeemed the preference shares. The assessee submitted that during the year under consideration, it earned the profit of Rs.28,35,16,379, therefore the assessee was able to repay the loan as well as redeem the preference shares of Rs.6 crores.

15. The AO was not satisfied with the explanation given by the assessee. The AO also observed that the assessee failed to produce substantial evidence in support of its contention. Therefore, he disallowed the interest paid on proportionate basis. He also disallowed the administrative, other expenses and financial charges on proportionate basis by considering the fact that for managing the investment portfolio the assessee must have incurred certain portion of those expenses debited to the profit and loss account. Therefore, the AO computed the proportionate disallowance u/s 14A as under :

> *"It is seen from the balance sheet that as on the balance sheet date the own capital of the company is at Rs.27,94,34,833/- and total borrowings is at Rs.52,90,70,980/- It is also seen from the P and L account that the assessee has incurred total interest expense of Rs.6,01,89,088/-. As against this, investments made in shares and securities is at Rs.27,06,64,720/-. The assessee was categorically asked to produce details of utilization of borrowed amount with supporting evidence on*

which interest is paid and debited to profit and loss account. It was required on the part of the assessee to show with necessary documentary evidence that the entire investment has been made out of the own funds and no part of the investment is made out of the interest bearing borrowed fund

As can be seen from the above that the borrowed funds (Rs.52,90,70,980/-) are more than the own funds (Rs.27,94,34,833) of the assessee. In the absence on the part of the assessee of showing the nexus of investment with own capital funds. I therefore, proceed to hold that the investment in the ratio of borrowed funds to the total funds is made out of borrowed funds and interest attributable to such funds to the total funds is made out of borrowed funds and interest attributable to such funds is held as incurred for earning exempted income.

Total funds	Rs.₹.80,85,05,813
Borrowed funds	Rs. 52,90,70,980
% of borrowed funds	64.44%
Total investment	Rs..27,06,64,720
Investment our of borrowed funds (64.44% of ₹.27,06,64,720)	Rs.17,71,22,993
Total interest paid	Rs..6,01,89,088
Therefore interest attributed to investment out of borrowed funds	6,01,89,088 x 17,71,22,993 52,90,70,980 = 2,01,50,172

In view of the above, interest expenses of Rs.2,01,50,172 is held as attributable to the investment out of borrowed funds. The amount of Rs..2,01,50,172 is disallowed under section 14A of the Act out of total interest payment made by the assessee.

Similarly, the disallowance u/s 14A out of administrative and other expenses and financial charges are also required to be made on proportionate basis. The same is made as under :

Total income credited	₹.39,03,43,325
Dividend income out of total income credited	₹ 2,98,92,569
% of dividend income to total income credited	7.66%
Total expenditure debited on account of financial charges (₹.34,16,176) and administrative and other expenses (₹.1,53,19,835)	₹.1,87,36,011

Therefore, the disallowance u/s 14A of the Act out of administrative and other expenses and financial charges comes to Rs..14,35,178, being 7.66% of Rs..187,36,001.

In view of the above, the total disallowance u/s 14A of the Act, comes to Rs..2,15,85,350/- which is nothing but the sum of Rs..2,01,50,172 disallowed out of interest payment and Rs.14,35,178/- disallowed out of administrative and other expenses and financial charges. "

16. On appeal, the CIT(A) held as under :

"3.3 I have gone through the arguments and submissions of the ld. AR as well as the contents of the impugned assessment order I do not find any merit in the arguments and submissions of the ld.

AR that there should not be any disallowance u/s 14A. There as various judgments in respect of applicability of section 14 A with reference to dividend income. In case of Citicorp Finance (India) Ltd 300 ITR 398, the Hon. ITAT, Mumbai observed that a company's investment decisions being complex in nature, require substantial market research, day-today- analysis of market trends and decisions with regard to acquisition, retention and sale of shares at the most appropriate time. The application of funds has there own inherent cost. Complex financial decisions require higher managerial skills and consequent high corporate expense. On the basis of these arguments, it was held that the AO must apportion the expenses to dividend earning activity reasonably.

3.3.1 It was held in the said decision that this provision is inherently retroactive in nature. However, this retroactivity part of the decision was subsequently set aside to be examined by the AO in pursuance to a Miscellaneous application filed by the appellant. This clearly establishes that the retroactivity of the provisions is not yet annulled.

3.3.2 In a subsequent decision, in the case of Union Bank of India V/s ACIT in IT ANo.5347/Mum/2007 also, the hon. Members have held that only the expenditure, which has been proved to have been incurred in relation to the earning of tax free income can be disallowed and the section cannot be extended to disallow even expenditure, which is assumed to have been incurred for the purposes of earning the tax free income. If these judgments by the Hon. Judicial tribunals are harmoniously analyzed. It is clearly established that the retroactivity of provisions of section 14A is not yet annulled. Expenses which can be related to the exempt income earning, need to be apportioned in a reasonable way. In order to set to rest the reasonableness with respect to such estimate, the CBDT has issued Rule 8D, which has been made operative from AY 2007-08. However, in the absence of a clear cut provision for such estimate before this day, it will be most appropriate for the assessing authority to apply Rule 8D for earlier years as well. Once the retroactivity and the need for apportionment of

expenses are established, the AO has some discretion about the estimate before AY 2007-08, but now that Rule 8D is already in the statute, it can give the most reasonable way of estimating the income.

3.3.3 In view of the facts and position of law stated in the preceding paragraphs, the AO is directed to re-compute the disallowance u/s 14A, keeping in view the principles laid down in Rule 8D of the Income Tax Rules, Grounds of appeal no.1,2 and 3 are thus, partly allowed"

17. Before us the learned AR of the assessee has submitted that during the previous year relevant to the assessment year under consideration the assessee earned a net profit of Rs..276,295,492/-from share trading. In addition, the assessee also earned profit from derivative transactions at Rs..72,06,558/-. The assessee also received dividend of Rs..2,98,92,569. The learned AR of the assessee has submitted that the assessing officer has made disallowance u/s 14A at Rs..21,585,350/- on the basis given by him at pages 10-11 of the assessment order. In brief, he has worked out in an arbitrary manner the estimated interest on proportionate borrowed funds allegedly employed in purchase of shares. The learned AR submitted that, in this manner, the AO has worked out the interest disallowable u/s 14A at Rs..20,150,172/-. Similarly, on proportionate basis he has attributed administrative and other expenses to the extent dividend income at Rs..1,435,178/-. The total disallowance u/s 14A thus made by the assessing officer is

Rs..21,585,350/-. On assessee's appeal learned CIT(A) has directed the assessing officer to recompute the disallowance u/s 14A keeping in view the principles laid down in Rule 8D of IT Rules.

18. The first and foremost contention of the assessee in this appeal is that no disallowance out of interest expenditure incurred by the assessee can be made u/s 14A. Assessment year under consideration is assessment year 2004-05. As held by Hon. Bombay high court in the case of Godrej and Boyce Manufacturing co. ltd Mumbai(234 DTR 1), the provisions of section 14A (2) and Rule 8D cannot be applied prior to assessment year 2008-09. In other words, for the assessment year under consideration i.e 2004-05 the assessing officer has to make disallowance u/s 14A, if any in accordance with the general provisions of the Act and on actual expenditure basis.

19. The learned AR of the assessee further submitted that the activity of purchase and sale of shares is mainly on treading account. The assessee has not purchased shares with a view to earn dividend income. Profit arising to the assessee on sale of shares in the trading account is chargeable to tax under the head "profits and gains of business or profession" and have been offered and assessed likewise. On these facts the assessee humbly submits that no

part of finance charges including interest paid by the assessee is disallowable u/s14A as expenditure incurred in relation to dividend received by the assessee. The assessee in this behalf strongly relied upon the judgment of Hon. Jurisdictional High Court in the case of CIT v.s Emerald co. ltd (2006) 284 ITR 586.

20. The assessee in this behalf relied upon the judgment of Hon. Calcutta High Court in the case of CIT V/s Kanoria Investment p ltd 232 ITR 007 (Cal) to the effect that even if the borrowed money is applied in purchase of shares which yield dividend, the entire interest paid on borrowing should be allowed as deduction in computing business income and no part of interest should be apportioned and deducted from dividend . The ld. A.R. has submitted that in the case of Mafatlal Holdings ltd V Addl.CIT 85 TTJ (Mumbai) 821 the Tribunal has held that the expression "for the purpose of the business in section 36(1) (iii) is wider in scope than "for the purpose of earning profits " Facts that the dividend income was exempt in the hands of the aseseee is no ground to disallow the interest.

21. The assessee submits that the shares were mainly purchased for the purpose of trading and not for earning dividend which are just incidental and by–product of the

assessee's trading activity. Hence, interest expenditure, if any, incurred to meet the cost of acquisition of shares can not be held to be expenditure incurred in relation to dividend. The aseseee places reliance in this regard on the decision of ITAT, Delhi in the case of ACIT V/s Eicher ltd 101 TTJ (Del) 369. It was held in that case that the expenditure which AO seeks to disallow under section 14A should be actually incurred and so incurred with a view to producing non-taxable income. Further more, hon. Bombay High Court in the case of CIT V/s General Insurance Corporation of India ltd (254 ITR 203 (Bom)) held that the expenditure that is not directly relatable to earning of dividend income cannot be deducted from deduction u/s 80M. Again in the case of CIT v. Central Bank of India 264 ITR 522 (Bom) a case of investment in shares and not trading in shares-hon. Bombay high Court has held that only actual interest paid on earning dividend is deductible and estimated proportionate expenditure is not deductible from gross dividend while working out deduction under section 80M. Reference in this regard was also made to the decision of the ITAT Calcutta in the case of Shaw Wallace and co. ltd 80ITD 158 (Cal) and judgment of MP High Court in the case of State Bank of Indore V.s CIT 275 ITR 23 (MP) also.

22. In view of the arguments as made in the foregoing paragraphs the learned AR of the assessee submitted that there cannot be any disallowance u/s14A even partially of the expenditure relating to buying and selling of shares as attributable to dividend received in the case of such shares being held as stock-in-trade. Secondly, without prejudice and as an alternate contention the assessee submitted that no disallowance of interest can be made on estimate basis without establishing the nexus between the interest bearing borrowings and purchase of shares on which dividend is received.

23. On the other hand, the learned DR has heavily relied upon the orders of the lower authorities. He has submitted that even otherwise the apportionment of the expenditure incurred in relation to the exempt income on reasonable basis is inherent in the provisions of section 14A. The provisions of section 14A does not make a difference whether any amount is incurred and debited in the trading account for trading activities or the said expenditure is incurred towards the other purchases. The provisions of section 14A are applicable if the assessee has earned the income which is not forming the part of the total income of the assessee and certain expenses are incurred for earning the said income. He has relied upon the decision of the Hon. jurisdictional High

Court in the case of Godrej and Boyce Mfg Co.Ltd V/s DCIT (234 CTR-(Bom).

24. We have considered the rival contentions and relevant record. The AO disallowed the interest expenditure on borrowed funds under the provisions of section 14A as well as the administrative expenditure by apportioning the same for earning the dividend income. The CIT(A) while passing the impugned order though principally agreed with the view of he AO as far as disallowance is concerned however, he directed the AO to recompute the disallowance under section 14A by applying the principle laid down under Rule 8D of the IT Rules, 1962.

Applicability of Rule 8D

25. We first take the issue of applicability of Rule 8D of he Income Tax Rules. In the recent decision in the case of The Hon. jurisdictional High Court in the case of Godrej and Boyce Mfg Co.Ltd V/s DCIT (234 DTR-(Bom)-1), the Hon. Jurisdictional High Court has held that the provisions of section 14A and Rule 8D cannot be applied prior to the assessment year 2008-09, the relevant paragraphs of the decision are as under :

"67. Even in the absence of sub sections (2) and (3) of Section 14A and of Rule 8D, the Assessing Officer

was not precluded from making apportionment. Such an apportionment would have to be made in order to give effect to the substantive provisions of sub section (1) of Section 14A which provide that no deduction would be allowed in respect of expenditure incurred in relation to income which does not form part of the total income under the Act. Consequently, dehors the provisions of Sections (2) and (3) of Section 14A and Rule 8D, the Assessing Officer was entitled to determine by the application of a reasonable method what quantum of the expenditure incurred by the assessee would have to be disallowed on the ground that it was incurred in relation to the earning of income which does not form part of the total income under the Act. Undoubtedly in determining what would constitute a reasonable method for effecting the disallowance, the Assessing Officer would have to give due regard to all the facts and circumstances of the case. The change which is brought about by the insertion of sub sections (2) and (3) into Section 14A by the Finance Act of 2006 with effect from 1 April 2007 is that in a situation where the Assessing Officer is not satisfied with the correctness of the claim of the assessee in regard to the expenditure incurred by it in relation to the nontaxable income, the Assessing Officer would have to follow the method which is prescribed by the rules. The rules were notified to come into force on 24 March 2008. It is a trite principle of law that the law which would apply to an assessment year is the law prevailing on the first day of April. Consequently, Rule 8D which has been notified on 24 March 2008 would apply with effect from Assessment Year 200809.The rule consequently cannot have application in respect of Assessment Year 2002-03 which is the year under consideration in this case."

26. Since the assessment year under consideration is assessment year 2004-05 therefore in view of the decision (supra) of the jurisdictional High Court, the provisions of Rule 8D cannot be applied.

Disallowance of proportionate Interest

27. Now we take up the controversy of disallowance of proportionate interests incurred for earning the dividend income. The CIT(A) in paragraph 3.3.2 as reproduced above has not been disputed, the settled legal proposition that only the expenditure which has been proved to have been incurred in relation to earn the tax free income can be disallowed and the provisions of section 14A cannot be extended to disallowed even the expenditure which is assumed to have been incurred for the purposes of earning the tax free income. The business of the assessee predominantly is trading in shares, securities and derivatives though the assessee was also having the investment in the shares and securities. The question arises whether the interest on borrowed funds is an expenditure incurred for earning the dividend income on the shares which were purchased for trading activities of the assessee and part of the stock-in-trade. As evident from the assessment order the AO has not disputed or contraverted the factual claim of the assessee that the dividend income is on the share which were purchased and held by the assessee for trading purposes and the dividend is directly credited in the D-mat account of the assessee. As per the memorandum explaining, the purpose behind the introduction of section 14A is the tax incentives given by way

of exemption of certain categories of income shall not be allowed to reduce the tax payable on the non- exempt income by debiting the expenses incurred to earn the income earned against the taxable income. Thus, the expenses incurred to earn exempt income cannot be allowed and the expenses shall be allowed only to the extent they are relatable to the earning of taxable income. The object and scheme of section 14A has been discussed by the Hon. Supreme Court, High Courts and this Tribunal on various occasions. Some of the relevant decisions in which this issue has been considered and analysed are discussed as under :

M/s. Walfort Share & Stock Brokers P. Ltd. ...326 ITR 1(SC)

> *"56.5 This amendment will take effect from 1st April, 2002, and will accordingly, apply in relation to the assessment year 2002-2003 and subsequent years. The main issue involved in this batch of cases is – whether in dividend stripping transaction (alleged to be colourable device by the Department) the loss on sale of units could be considered as expenditure in relation to earning of dividend income exempt under Section 10(33), disallowable under Section 14A of the Act? According to the Department, the differential amount between the purchase and sale price of the units constituted "expenditure incurred" by the assessee for earning tax-free income, hence, liable to be disallowed under Section 14A. As a result of the dividend pay-out, according to the Department, the NAV of the mutual fund, which was Rs. 17.23 per unit on the record date, fell to Rs. 13.23 on 27.3.2000 (the next trading date) and, thus, Rs. 4/- per unit, according to the Department, constituted "expenditure incurred" in terms of Section 14A of the Act. In its return, the assessee, thus, claimed the dividend received as exempt under Section 10(33) and also*

claimed set-off for the loss against its taxable income, thereby seeking to reduce its tax liability and gain tax advantage. The insertion of Section 14A with retrospective effect is the serious attempt on the part of the Parliament not to allow deduction in respect of any expenditure incurred by the assessee in relation to income, which does not form part of the total income under the Act against the taxable income (see Circular No. 14 of 2001 dated 22.11.2001). In other words, Section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. In many cases the nature of expenses incurred by the assessee may be relatable partly to the exempt income and partly to the taxable income. In the absence of Section 14A, the expenditure incurred in respect of exempt income was being claimed against taxable income. The mandate of Section 14A is clear. It desires to curb the practice to claim deduction of expenses incurred in relation to exempt income against taxable income and at the same time avail the tax incentive by way of exemption of exempt income without making any apportionment of expenses incurred in relation to exempt income. The basic reason for insertion of Section 14A is that certain incomes are not includible while computing total income as these are exempt under certain provisions of the Act. In the past, there have been cases in which deduction has been sought in respect of such incomes which in effect would mean that tax incentives to certain incomes was being used to reduce the tax payable on the non-exempt income by debiting the expenses, incurred to earn the exempt income, against taxable income. The basic principle of taxation is to tax the net income, i.e., gross income minus the expenditure. On the same analogy the exemption is also in respect of net income. Expenses allowed can only be in respect of earning of taxable income. This is the purport of Section 14A. In Section 14A, the first phrase is "for the purposes of computing the total income under this Chapter" which makes it clear that various heads of income as prescribed under Chapter IV would fall within Section 14A. The next phrase is, "in relation to income which does not form part of total income under the Act". It means that if an income does not form part of total income, then the related expenditure is outside the ambit of the applicability of Section 14A. Further, Section 14 specifies five heads of income which are

chargeable to tax. In order to be chargeable, an income has to be brought under one of the five heads. Sections 15 to 59 lay down the rules for computing income for the purpose of chargeability to tax under those heads. Sections 15 to 59 quantify the total income chargeable to tax. The permissible deductions enumerated in Sections 15 to 59 are now to be allowed only with reference to income which is brought under one of the above heads and is chargeable to tax. If an income like dividend income is not a part of the total income, the expenditure/ deduction though of the nature specified in Sections 15 to 59 but related to the income not forming part of total income could not be allowed against other income includible in the total income for the purpose of chargeability to tax. The theory of apportionment of expenditures between taxable and non-taxable has, in principle, been now widened under Section 14A. Reading Section 14 in juxtaposition with Sections 15 to 59, it is clear that the words "expenditure incurred" in Section 14A refers to expenditure on rent, taxes, salaries, interest, etc. in respect of which allowances are provided for (see Sections 30 to 37). Every pay-out is not entitled to allowances for deduction. These allowances are admissible to qualified deductions. These deductions are for debits in the real sense. A pay-back does not constitute an "expenditure incurred" in terms of Section 14A. Even applying the principles of accountancy, a pay-back in the strict sense does not constitute an "expenditure" as it does not impact the Profit & Loss Account. Pay-back or return of investment will impact the balance-sheet whereas return on investment will impact the Profit & Loss Account. Cost of acquisition of an asset impacts the balance sheet. Return of investment brings down the cost. It will not increase the expenditure. Hence, expenditure, return on investment, return of investment and cost of acquisition are distinct concepts. Therefore, one needs to read the words "expenditure incurred" in Section 14A in the context of the scheme of the Act and, if so read, it is clear that it disallows certain expenditures incurred to earn exempt income from being deducted from other income which is includible in the "total income" for the purpose of chargeability to tax. As stated above, the scheme of Sections 30 to 37 is that profits and gains must be computed subject to certain allowances for deductions/ expenditure. The charge is not on gross

receipts, it is on profits and gains. Profits have to be computed after deducting losses and expenses incurred for business. A deduction for expenditure or loss which is not within the prohibition must be allowed if it is on the facts of the case a proper Debit Item to be charged against the Incomings of the business in ascertaining the true profits. A return of investment or a pay-back is not such a Debit Item as explained above, hence, it is not "expenditure incurred" in terms of Section 14A. Expenditure is a pay-out. It relates to disbursement. A pay-back is not an expenditure in the scheme of Section 14A. For attracting Section 14A, there has to be a proximate cause for disallowance, which is its relationship with the tax exempt income. Pay-back or return of investment is not such proximate cause, hence, Section 14A is not applicable in the present case. Thus, in the absence of such proximate cause for disallowance, Section 14A cannot be invoked. In our view, return of investment cannot be construed to mean "expenditure" and if it is construed to mean "expenditure" in the sense of physical spending still the expenditure was not such as could be claimed as an "allowance" against the profits of the relevant accounting year under Sections 30 to 37 of the Act and, therefore, Section 14A cannot be invoked. Hence, the two asset theory is not applicable in this case as there is no expenditure incurred in terms of Section 14A. The next point which arises for determination is whether the "loss" pertaining to exempted income was deductible against the chargeable income. In other words, whether the loss in the sale of units could be disallowed on the ground that the impugned transaction was a transaction of dividend stripping. The AO in the present case has disallowed the loss of Rs. 1,82,12,862 on the sale of 40% tax-free units of the mutual fund. The AO held that the assessee had purposely and in a planned manner entered into a pre-meditated transaction of buying and selling units yielding exempted income with the full knowledge about the guaranteed fall in the market value of the units and the payment of tax-free dividend, hence, disallowance of the loss. In the lead case, we are concerned with the assessment years prior to insertion of Section 94(7) vide Finance Act, 2001 w.e.f. 1.4.2002. We are of the view that the AO had erred in disallowing the loss. In the case of ***Vijaya Bank*** *v.* ***Additional Commissioner of Income***

Tax *[1991] 187 ITR 541, it was held by this Court that where the assessee buys securities at a price determined with reference to their actual value as well as interest accrued thereon till the date of purchase the entire price paid would be in the nature of capital outlay and no part of it can be set off as expenditure against income accruing on those securities. The real objection of the Department appears to be that the assessee is getting tax-free dividend; that at the same time it is claiming loss on the sale of the units; that the assessee had purposely and in a planned manner entered into a pre-meditated transaction of buying and selling units yielding exempted dividends with full knowledge about the fall in the NAV after the record date and the payment of tax-free dividend and, therefore, loss on sale was not genuine. We find no merit in the above argument of the Department. At the outset, we may state that we have two sets of cases before us. The lead matter covers assessment years before insertion of Section 94(7) vide Finance Act, 2001 w.e.f. 1.4.2002. With regard to such cases we may state that on facts it is established that there was a "sale". The sale-price was received by the assessee. That, the assessee did receive dividend. The fact that the dividend received was tax-free is the position recognized under Section 10(33) of the Act. The assessee had made use of the said provision of the Act. That such use cannot be called "abuse of law". Even assuming that the transaction was pre-planned there is nothing to impeach the genuineness of the transaction. With regard to the ruling in* ***McDowell & Co. Ltd.*** *v.* ***Commercial Tax Officer*** *[154 ITR 148(SC)], it may be stated that in the later decision of this Court in* ***Union of India*** *v.* ***Azadi Bachao Andolan*** *[263 ITR 706(SC)] it has been held that a citizen is free to carry on its business within the four corners of the law. That, mere tax planning, without any motive to evade taxes through colourable devices is not frowned upon even by the judgment of this Court in* ***McDowell & Co. Ltd.'s case (supra)****. Hence, in the cases arising before 1.4.2002, losses pertaining to exempted income cannot be disallowed. However, after 1.4.2002, such losses to the extent of dividend received by the assessee could be ignored by the AO in view of Section 94(7). The object of Section 94(7) is to curb the short term losses. Applying Section 94(7) in a case for the assessment year(s) falling after 1.4.2002, the loss to be ignored*

would be only to the extent of the dividend received and not the entire loss. In other words, losses over and above the amount of the dividend received would still be allowed from which it follows that the Parliament has not treated the dividend stripping transaction as sham or bogus. It has not treated the entire loss as fictitious or only a fiscal loss. After 1.4.2002, losses over and above the dividend received will not be ignored under Section 94(7). If the argument of the Department is to be accepted, it would mean that before 1.4.2002 the entire loss would be disallowed as not genuine but, after 1.4.2002, a part of it would be allowable under Section 94(7) which cannot be the object of Section 94(7) which is inserted to curb tax avoidance by certain types of transactions in securities. There is one more way of answering this point. Sections 14A and 94(7) were simultaneously inserted by the same Finance Act, 2001. As stated above, Section 14A was inserted w.e.f. 1.4.1962 whereas Section 94(7) was inserted w.e.f. 1.4.2002. The reason is obvious. Parliament realized that several public sector undertakings and public sector enterprises had invested huge amounts over last couple of years in the impugned dividend stripping transactions so also declaration of dividends by mutual fund are being vetted and regulated by SEBI for last couple of years. If Section 94(7) would have been brought into effect from 1.4.1962, as in the case of Section 14A, it would have resulted in reversal of large number of transactions. This could be one reason why the Parliament intended to give effect to Section 94(7) only w.e.f. 1.4.2002. It is important to clarify that this last reasoning has nothing to do with the interpretations given by us to Sections 14A and 94(7). However, it is the duty of the court to examine the circumstances and reasons why Section 14A inserted by Finance Act 2001 stood inserted w.e.f. 1.4.1962 while Section 94(7) inserted by the same Finance Act as brought into force w.e.f. 1.4.2002. The next question which we need to decide is about reconciliation of Sections 14A and 94(7). In our view, the two operate in different fields. As stated above, Section 14A deals with disallowance of expenditure incurred in earning tax-free income against the profits of the accounting year under Sections 30 to 37 of the Act. On the other hand, Section 94(7) refers to disallowance of the loss on the acquisition of an asset which situation is not there in

cases falling under Section 14A. Under Section 94(7) the dividend goes to reduce the loss. It applies to cases where the loss is more than the dividend. Section 14A applies to cases where the assessee incurs expenditure to earn tax free income but where there is no acquisition of an asset. In cases falling under Section 94(7), there is acquisition of an asset and existence of the loss which arises at a point of time subsequent to the purchase of units and receipt of exempt income. It occurs only when the sale takes place. Section 14A comes in when there is claim for deduction of an expenditure whereas Section 94(7) comes in when there is claim for allowance for the business loss. We may reiterate that one must keep in mind the conceptual difference between loss, expenditure, cost of acquisition, etc. while interpreting the scheme of the Act. Before concluding, one aspect concerning Para 12 of Accounting Standard AS-13 relied upon by the Revenue needs to be highlighted. Para 12 indicates that interest/ dividends received on investments are generally regarded as return on investment and not return of investment. It is only in certain circumstances where the purchase price includes the right to receive crystallized and accrued dividends/ interest, that have already accrued and become due for payment before the date of purchase of the units, that the same has got to be reduced from the purchase cost of the investment. A mere receipt of dividend subsequent to purchase of units, on the basis of a person holding units at the time of declaration of dividend on the record date, cannot go to offset the cost of acquisition of the units. Therefore, AS-13 has no application to the facts of the present cases where units are bought at the ruling NAV with a right to receive dividend as and when declared in future and did not carry any vested right to claim dividends which had already accrued prior to the purchase. For the above reasons, we find no infirmity in the impugned judgment of the High Court and, accordingly, these Civil Appeals filed by the Department are dismissed with no order as to costs."

(emphasis supplied)

28. As observed by the Hon. Apex Court the basic principle of taxation is to tax the net income and on the same analogy the exemption is also allowed in respect of the net exempted income. Therefore, if there is an expenditure directly or indirectly incurred in relation to the exempt income the same cannot be claimed against the income which is taxable. The Hon. Supreme Court has laid down the principle for attracting the provisions of section 14A that here should be proximate cause for disallowance which has relationship with the tax exempt income. The Hon'ble. Jurisdictional High Court in the case of Godrej and Boyce Mfg co. ltd V/s Dy CIT (supra) has also taken note of the decision of the honourable Supreme Court in the case of CIT V/s Wallfort Share and Stock Brokers pvt ltd (supra) in para 24 as under :

> *"24. The following principles would emerge from Section 14A and the decision in Walfort:*
>
> *(a) The mandate of Section 14A is to prevent claims for deduction of expenditure in relation to income which does not form part of the total income of the assessee;*
>
> *(b) Section 14A(1) is enacted to ensure that only expenses incurred in respect of earning taxable income are allowed;*
>
> *(c) The principle of apportionment of expenses is widened by Section 14A to include even the apportionment of expenditure between taxable and nontaxable income of an indivisible business;*

(d) The basic principle of taxation is to tax net income. This principle applies even for the purposes of Section 14A and expenses towards nontaxable income must be excluded;

(e) Once a proximate cause for disallowance is established –which is the relationship of the expenditure with income which does not form part of the total income – a disallowance has to be effected. All expenditure incurred in relation to income which does not form part of the total income under the provisions of the Act has to be disallowed under Section 14A. Income which does not form part of the total income is broadly adverted to as exempt income as an abbreviated appellation."

29. The Hon. High Court has further observed and summarized the conclusion in paragraph 43 as under :

"A Summation of our conclusions on the interpretation of the provisions:

43. In order to conclude the discussion on this aspect of the case, we would proceed to recapitulate our conclusions.

(i) Section 14A was enacted by Parliament in order to overcome the judgments of the Supreme Court in the case of Indian bank, Maharashtra Sugar and Rajasthan Warehousing Corporation in which it was held that in the case of a composite and indivisible business, which results in earning of taxable and nontaxable income, it is impermissible to apportion the expenditure between that which was laid out for the earning of taxable as opposed to nontaxable income;

(ii) The effect of Section 14A is to widen the theory of the apportionment of expenditure. Prior to the enactment of Section14A where the business of an assessee was not a composite and indivisible business and the assessee earned both taxable and nontaxable income, the expenditure incurred on earning nontaxable income could not be allowed as a

deduction as against the taxable income. As a result of the enactment of Section 14A, no expenditure can be allowed as a deduction in relation to income which does not form part of the total income under the Act. Hence, even in the case of a composite and indivisible business, which results in the earning of taxable and nontaxable income, it would be necessary to apportion the expenditure incurred by the assessee. Only that part of the expenditure which is incurred in relation to income which forms part of the total income can be allowed. The expenditure incurred in relation to income which does not form part of the total income has to be disallowed;

(iii) From this it would follow that Section 14A has implicit within it a notion of apportionment. The principle of apportionment which prior to the amendment of Section14A would not have applied to expenditure incurred in a composite and indivisible business which results in taxable and nontaxable income, must after the enactment of the provisions apply even to such a situation;

(iv) The expression "expenditure incurred" in Section 14A refers to expenditure on rent, taxes, salaries, interest etc. in respect of which allowances are provided for;

(v) Subsections (2) and (3) of Section 14A are intended to enforce and implement the provisions of Subsection (1). The object of subsection (2) is to provide a uniformity of method where the Assessing Officer is, on the basis of the accounts of the assessee, 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 the Act;

-(vi) Even in the absence of sub-section (2) of Section 14A, the Assessing Officer would have to apportion the expenditure and to disallow the expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Assessing Officer would have to follow a reasonable method of apportioning the expenditure consistent with what the circumstances of the case

would warrant and having regard to all the relevant facts and circumstances;

(v).....
(vi).....
(vii).....
(viii).....
(ix).....
(x).....
(xi).....
(xii).....

(xiii) Income from dividend and similarly, income from mutual funds do not form part of the total income under Section 10(33).The expenditure incurred in relation to earning such income cannot be allowed under Section 14A;

(xiv) In order to determine the quantum of the disallowance, there must be a proximate relationship between the expenditure and the income which does not form part of the total income. Once such a proximate relationship exists, the disallowance has to be effected. All expenditure incurred in the earning of income which does not form part of the total income has to be disallowed subject to compliance with the test adopted by the Supreme Court in Walfort and it would not be permissible to restrict the provisions of Section 14A by an artificial method of interpretation..."

30. It is clear from the above decision of the hon'ble jurisdictional High Court that the expenditure incurred on the earning of the non taxable income should not be allowed as deduction against the taxable income. Even in the case of composite/indivisible business which results the earning of both taxable and non taxable income, it would be necessary to apportion the expenditure incurred by the assessee. Only that part of the expenditure which is incurred in relation to the

income which form the part of the total income should be allowed. The expenditure incurred in relation to the income which does not form the part of the total income has to be disallowed. The Hon'ble High Court further observed that section 14A has implicit within it a notion of apportionment. Even prior to the amendment whereby the sub-section 2 of section 14A was brought into the statute, the AO would have to apportion the expenditure and disallow the expenditure incurred by the assessee in relation to the income which does not form part of the total income. The Hon. jurisdictional High Court held that the AO has to follow a reasonable method of apportioning the expenditure consistent with what the circumference of the case would warrant and having regard to all relevant facts and circumstances. There must be a proximate relationship between the expenditure and the income which does not form part of the total income. Once such a proximate relationship exists, the disallowance has to be effected. All expenditure incurred in the earning of income which does not form part of the total income has to be disallowed subject to compliance with the test adopted by the Supreme Court in Walfort and it would not be permissible to restrict the provisions of Section 14A by an artificial method of interpretation. Thus, in view of the decision of the jurisdictional High Court in the case of Godrej and Boyce Mfg

co. ltd V/s Dy CIT (supra) even if the assessee has claimed that he has not incurred any expenditure for earning the exempt income "dividend" the applicability of provisions of section 14A cannot be ruled out.. It is for the AO to determine as to whether the assessee had incurred any expenditure in relation to the income which does not form the part of the total income and if so to quantify the extent of the disallowance as held in para 73 of the decision(supra) as under:

> *"73. For the reasons which we have indicated, we have come to the conclusion that under Section 14A(1) it is for the Assessing Officer to determine as to whether the assessee had incurred any expenditure in relation to the earning of income which does not form part of the total income under the Act and if so to quantify the extent of the disallowance. The Assessing Officer would have to arrive at his determination after furnishing an opportunity to the assessee to produce its accounts and to place on the record all relevant material in support of the circumstances which are considered to be relevant and germane. For this purpose and in light of our observations made earlier in this section of the judgment, we deem it appropriate and proper to remand the proceedings back to the Assessing Officer for a fresh determination."*

31. As relied upon by the learned AR the Delhi Bench of the Tribunal in the case of ACIT V/s Eicher Ltd reported in (2006) TTJ (Del) 369 elaborately discussed this issue in paragraph 14,15, 20, 21 and 22 as under :

> *"14. Sec 14A gives the AO the power to disallow expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The precise question that*

on record that the assessee in fact incurred expenditure to produce non-taxable income which he may disallow or whether he can estimate a part of the expenditure incurred by the assessee as expenditure incurred to produce non-taxable income on the assumption that a part of the language of the section shows that he AO can disallow only expenditure "incurred" by the assessee in relation to the exempt income. The word "incurred" clearly implies that it must be shown as a fact that some expenditure was in fact incurred by he assessee to produce exempted income. It was open to the legislature to confer power upon he AO to assume that a part of the expenditure must have necessarily been incurred to produce exempted income which he AO can estimate and disallow and accordingly, use suitable expressions in the section conferring such power upon the AO. One such instances is s 38(2) "to a fair proportionate part thereof which he AO may determine having regard to the use of such building, machinery, plant or furniture for the purposes of the business or profession" Another such instances of S.40A(2)(a) which gives power to the AO to determine, based on his own opinion , as to how much expenditure incurred by the assessee in respect of which payments made to closely related persons or concern, is excessive or unreasonable having regard to the fair market value of goods, services or facilities for which the payment is made or the legitimate needs of the business or he benefit derived by the assessee from the expenditure. But, when s. 14A has not given such specific power to the AO, he has no authority to estimate the expenditure which he assessee would have , in the opinion of the AO incurred in relation to the exempted income. The words "in relation to" income which is exempt read in conjunction with the word "incurred", it seems to us that these are restrictive words, restricting the power of the AO to estimate a part of the expenditure incurred by he assessee as relatable to the exempted income. It seems to us that implicit in the expression "in relation to " is the concept that the AO should be in a position to pin point, with an acceptable degree of accuracy, the expenditure which was incurred by he assessee to produce non-taxable income. The word "incurred"

signified that the expenditure must have been actually incurred, not notionally.

15. Reading both the above mentioned expressions together, the conclusion seems inescapable that the expenditure which he AO seeks to disallow under section 14A should be actually incurred and so incurred with a view to producing non-taxable income. If this much is clear from the section, it follows that it is the duty of the AO to pin point such expenditure on the basis of the material on record.

16....

17....

18....

19...

20. Section 14A does not seek to touch upon the above controversy at all. In fact, it cannot, because the controversy has been settled in favour of the revenue both judicially as well as statutorily as noted above. Now s 14A as explained by he Memorandum explaining the provisions of the Finance bill, 2001, which we have already quoted above, seeks to nullify the effect of certain judgments in which it has been held that in the case of an indivisible business, no part of the expenditure incurred by the assessee can be disallowed as relating to the exempted income. Obviously, the decision which the finance bill sought to nullify are those in the case of Indian Bank (supra), Maharashtra Sugar Mills td (supra) and Rajasthan State Warehousing Corp. (supra) Both the memorandum explaining he Finance Bill and the section as enacted say that only where the expenditure has been actually incurred by the assessee in relation to the exempt income, can the AO refuse to allow deduction in respect of the same. To the extent the earlier judgments held that the AO had no power to do so, they stand nullified by s. 14A without any doubt. The section confers power or authority upon the AO to disallow such expenditure as satisfies the requirements of the section. What the AO could not do earlier, in

view of three binding judgments of the Supreme Court on the question, he can now do under section 14A. The power is, however, subject to the rider that he must show that the assessee in fact incurred expenditure which is related to the exempted income. It, therefore, appears to us clear that the section only removes the disability on the part of the AO to disallow such expenditure, a disability to which he was subjected by the three judgments of the Supreme Court cited supra. The mere removal of the disability statutorily, however does not ipso fact authorize him to assume that a part of the expenditure has been incurred by he assessee in relation to the exempted income and to proceed to disallow the same on estimate The section does not, in our opinion, relieve the AO of the burden of proving, on the basis of evidence or material on record that the assessee has in fact incurred expenditure which has relation to the exempted income. Even in regard to section 80M, the Calcutta and Madhya Pradesh High Courts have held that he AO cannot estimate and disallow any notional or adhoc expenditure to reduce the dividend income. The Calcutta view is embodies in the following judgments :

a) CIT V/s National and Grindlays Bank ltd (1993) 109 CTR (Cal) 264 ☹1993) 202 ITR 559 (CAL)

b) CIT V/s United Colleries ltd (1993) 203 ITR 857 (Cal0;

c) CIT V/s Enemour Investmetns ltd (1994) 72 Taxman 370 (Cal)

In these judgments, It has been consistently held that "only the factual expenditure incurred by he assessee in earning the dividend income shall be deduced from he gross dividend income There is no scope for any estimate of expenditure being made and no notional expenditure can be allocated also for the purpose of earning income unless the facts of a particular case warrant such allocation"

(underlining, italicized in print, ours)

Referring to the above judgments, the Madhyapradesh High COURT held in State Bank of Indore V/s CIT (2005) 193 CTR (MP) 62 : 2005 144 Taxman 72 (MP) as under :

"13....the question.....encasing the dividend"

Having held as above, the High Court proceeded to hold that the view that hey have taken " is not in conflict with the decision of Supreme Court in Distributors (Baroda)(P) Ltd's case (supra) Indeed, we may make it clear that in case, if the taxing authorities or assessee as the case may be is able to prove or show that a particular amount was actually incurred has got to be deduced from gross dividend income and then the same is to be taken into consideration under section 80M (underlining, italicized in print ours)

It was further observed that since in the case before the High Court "the taxing authorities have not taken into consideration the actual expenditure incurred by an assessee while earning the dividend but has only proceeded to take notional expenditure, the same cannot be held to be sustainable in law " and that " it is not in accordance with the view even taken by Supreme Court in the case of Distributors (Baroda)(P) Ltd (supra) underlining, italicized in print ours). Two aspects stand out, on a perusal of the above judgments. First, that the High Court have not authorized the disallowance of any notional expenditure (as against actual expenditure) to reduce the income in respect of which deduction is claimed and second, that in the case before the Calcutta High Court in Enemour Investments. Ld. (supra) and the Madhya Prdesh High Court in State Bank of Indore (supra) even the revenue has not relied on the judgment of he Supreme Court in CIT V/s United General Trust ltd (supra) thereby suggesting that in its understanding also that judgment cannot be understood as authority for permitting an estimated or notional expenditure to be disallowed in order to reduce the income eligible for the deduction.
21. Having held as above, we now proceed to examine whether there is any evidence or material

on record in the present case authorizing the AO to invoke s. 14A for the purpose of disallowing the expenditure of Rs.5 lakhs. There is no dispute that the entire dividend of Rs.83,02,635 which is exempt under section 10(33) was received fro M/s Eicher Motors ltd by a single dividend warrant and no effort or expenses were necessary or were incurred to earn such income. There is also no material brought before us to show that the assessee's contention that no part of the interest can be attributed to the earning of the dividend income since the shares were acquired from the own funds in the earlier years and not from borrowed funds, is factually incurred. In these circumstances, we have to agree with the assessee that there is no material on the basis of which the AO would estimate and disallow a sum of Rs.,5 lakhs by invoking s 14A. We therefore, agree with the decision of the CIT(A), affirm the same and dismiss the ground no.3.

22. In the course of the arguments, reference was made to the order of the Delhi Bench of the Tribunal in the case of Maruti Udyog ltd V/s DCIT (2005) 92 TTJ(Del) 987 : (2005) 92 ITD 119 (Del) in which a question of disallowance under section 14A arose and was considered. A perusal of the order of the tribunal shows that the purely legal aspect of the matter has been discussed in para 59-61 of the order. The question before the tribunal was whether any part of the interest paid by the assessee on borrowed funds can be disallowed under section 14A on that ground that the assessee had received dividend income exempt under section 10(33). It appears to have been contended before the tribunal that s 14A does not override the provisions of s 36(1)(iii) of the Act. This contention was rejected by the tribunal by holding that the language employed by s 14A is very wide and includes every expenditure irrespective of the head under which it is claimed. The tribunal further proceeded to hold and we are respectfully in agreement with the same that the burden under section 14A is on the revenue to prove that interest paid by the assessee on borrowed funds related to the acquisition of shares yielding tax-free income. In paragraph 61, the tribunal further held that the words "in relation to"

appearing in the section would include any expenditure which is proved (by the revenue) to have nexus directly or indirectly with the utilization of the funds for earning tax-free income. The question whether it was the duty of the AO to prove on the basis of material on record that the assessee actually incurred expenditure in relation to the exempted income did not precisely arise before the tribunal nor has it been decided specifically. However, it seem to us that the decision could be construed as holding, albeit immediately that only actual expenditure incurred in relation to exempted income can be disallowed, because the tribunal in terms held that the onus is on the revenue to prove that interest paid by the assessee on borrowed funds related to acquisition of shares yielding tax free income. Obviously, the revenue would be in a position to discharge the burden only on the basis of material on record to show that interest (or any other expenditure) was paid by the assessee on funds borrowed for acquiring the shares. It seems to us with respect, that it is possible to understand the order of the Tribunal in Maruti Udyog ltd (supra) as also laying done that only actual expenditure incurred by he assessee to earn exempted income can be disallowed by the AO u/s 14A"

32. From the decisions as discussed above it is settled that in order to disallow the expenditure u/s 14A of the Act there should be some expenditure actually incurred for earning the exempt income. Thus, the primary condition for disallowance is factual incurrence of expenditure in relation to the income not forming the part of the total income.

33. As it is clear from the memorandum of explanation the purpose of introduction of the section as well as from the various decisions (supra) that exemption is allowable only to

the net income which does not form the part of the total income. In other word the entire expenditure incurred for earning the exempt income shall be allowed only against the exempt income and not against the taxable income.

34. It is pertinent to note that the interest on borrowed funds used for trading activity is an allowable expenditure under section 36(1)(iii) and the same cannot be treated as the expenditure for earning the dividend income which is incidental to the trading activity as held by he Hon. High Court in the case of CIT v/s Emraid Co.ltd (284 ITR 586) has held in paragraphs 8-12,17,21 as under :

> *"8. The issue for consideration is whether interest paid on borrowings used for purchase of shares held s stock-in-trade is to be taken into account under section 36(1)(iii) in computing the income from trading in shares under the head "business" and consequently, is not to be reduced from he dividend income which would result in deduction under section 80M being allowed on the full amount of the dividend.*
>
> *9. It must be borne in mind that in the case in hand, the assessee is a trader dealing specifically in shares and that his business is trading in shares. His income, therefore from trading in shares is required to be assessed under the head "business" and since the shares have been purchased out of borrowed funds, the interest on such borrowings is allowable under section 36(1)(iii) as it is incurred for the purpose of his business section 36(1)(iii) reads as follows :*
>
> ***"Other deductions.***
> ***36.*** *(1) The deductions provided for in the following clauses shall be allowed in respect of the*

matters dealt with therein, in computing the income referred to in section 28—

(i) xxxxxxxxxx

ii) xxxxxxxx

(iii) the amount of the interest paid in respect of capital borrowed for the purposes of the business or profession :

Explanation.—Recurring subscriptions paid periodically by shareholders, or subscribers in Mutual Benefit Societies which fulfill such conditions as may be prescribed, shall be deemed to be capital borrowed within the meaning of this clause;

Sec.28 sets out what income shall be chargeable to income tax under the head "profit and gains of business or profession

10. Clause (iii) of s 36(1) makes allowance in respect of interest paid on capital borrowed for the purposes of business or profession. The dividend earned on such shares is assessed under the head "other sources". Any expenditure incurred wholly or exclusively for the purposes of earning the dividend income is to be deduced under section 57(iii). Sec. 57(iii) reads as follows:

"

Deductions.

57. *The income chargeable under the head "Income from other sources" shall be computed after making the following deductions, namely :—*

(i) xxxxxx

(ii) xxxxxxxxxxx

(iii) any other expenditure (not being in the nature of capital expenditure) laid out or expended wholly and exclusively for the purpose[12] of making or earning such income.

11. In the case of an investor, the interest paid on borrowed funds used for purchase of shares would be deduced out of the dividend income. Since the dividend income included in the gross

total income would be the net dividend (gross dividend minus interest), deduction under section 80M would be allowed thereof.

12. In the present case, since the assessee is a trader, though dividend is separately assessable under section 56, it does not cease to be a business income.

"Income from other sources.

56. *(1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head "Income from other sources", if it is not chargeable to income-tax under any of the heads specified in section 14, items A to E.*

(2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head "Income from other sources", namely :—

(i) dividends ;"

13. Business income is broken up under the different heads only for the purposes of computing total income, but the income does not cease to be income of the business.

14. Therefore in the case of dealer in shares, as in the present case, the dividend retains the character of business income though assessed under section 56. The interest on he borrowings is paid for the purpose of business and, therefore, allowable under section 36(1)(iii). The interest paid is not expenditure laid out or expended wholly or exclusively for the purpose of earning the dividend as required under section 57(iii) and therefore, should not be reduced under section 57 from the dividend income.

15...

16.

17. The decision of the Supreme Court in the case of Distributors(Baroda)(P) ltd (supra) is distinguishable on facts as that case was limited to the question whether deduction under section 80M was available with respect to the gross or net amount of dividend in a case where the assessee was an investment company and not a trader dealing in shares. It may be noted that the principle laid down in Distributors (Baroda) (P) Ltd (supra) wherein the SUPREME Court construed the expression such income by way of dividend " in s 80M as dividend included in the gross income which would be the dividend computed in accordance with the provisions of the Act that is, the net dividend, has been incorporated in the Act by s 80AA which has now been omitted w.e.f 1st April, 1998 .

18. In the case on hand, the interest on the overdraft and the expenses are related to the business of trading in shares and ought to be allowed as computed income under the head "business". The said expenses cannot be once again be deducted from the dividend income for the limited purposes of computing the deduction under section 80M of the Act. There is no statutory provisions requiring the AO to deduct the same expenses under two different heads of income. Since the income by way of dividend included in the gross total income is Rs.1,34,984, the deduction under section 80M has to be granted with reference to the said amount of Rs.1,34,984.

19. in the light of above discussion, we uphold the decision of the tribunal and answer the question in the affirmative, in favour of the assessee and against the revenue "

35. Thus, undisputedly, when the real purpose and intent to use the borrowed funds was for trading activity and if incidentally resulted some dividend income on the shares purchased for trading then the same would no change the

purpose, nature or character of the expenditure. Thus, when the said expenditure (interest) incurred for trading activity then the same cannot be said to have been incurred for earning the dividend income. As per the basic principle of taxation only the net income i.e. gross income minus expenditure incurred is taxed. Accordingly, the expenditure which was incurred for earning the taxable business income has to be allowed against the taxable income and the question of apportionment of the said expenditure does not arise. The expression "in relation to " used in section 14A mean dominant and immediate connection or nexus. Thus, in order to disallowed the expenditure u/s 14A there must be a live nexus between the expenditure incurred and the income not forming the part of the total income. As held by the Delhi Bench of the Tribunal in the case of Escort disallowance cannot be made on the basis of presumption and estimation of the AO. No notional expenditure can be apportioned for the purpose of earning income unless there is an actual expenditure " in relation to" earning the income not forming the part of the total income. If the expenditure is incurred with a view to earn taxable income and there is apparent dominant and immediate connection between the expenditure incurred and taxable income then as such no disallowance can be made under section 14A merely because, some tax

exempt income is received incidentally. In case of dealer in shares and securities the primary object and intention for acquisition of the shares is to earn profit on trading of shares. The income on sale and purchase of the shares of a dealer is chargeable to tax. Therefore, if the said activity of purchase and sale also incidentally yield some dividend income on the shares held by him as stock-in-trade such dividend income is not intended at the time of purchases of such shares and accordingly there is no live connection between the expenditure incurred and dividend income. The similar view was taken by the The Hon.Kerala High Court in the case of CIT V/s Smt.Leena Ramchandranan M/s Homfit, in ITA No.1784 of 2009, order dated 14.6.2010 has held as under :

> *"4. On facts we find that the interest paid by the assessee during the previous year for the funds borrowed for acquisition of shares in the company was at the rate of 24% p.a. and the total interest paid in the accounting year alone is as much as Rs.17,44,310/-. It is on record that assessee had received only a dividend income of Rs.3 lakhs and no other benefit is derived from the company for the business carried on by it. The disallowance prohibited under Section 14A is expenditure incurred for earning any income which does not constitute total income of the assessee. In other words, any expenditure incurred for earning any income which is not taxable under the Act, is not an allowable expenditure. Dividend income is exempt under Section 10(33) of the Income Tax Act and so much so, dividend earned by the assessee on the shares acquired by her with borrowed funds does not constitute total income in the hands of the*

assessee. So much so, in our view, disallowance was rightly made by the Assessing Officer. In fact, the Tribunal itself has estimated disallowance of Rs.2 lakhs by applying Section 14A. We do not know how the Tribunal can restrict the disallowance to Rs.2 lakhs and allow balance above Rs.15 lakhs when the whole borrowed funds were utilised by the assessee for purchase of shares in the company. In our view, the reasoning given by the Tribunal for disallowance of Rs.2 lakhs i.e. by applying Section 14A, squarely applies for the interest paid on borrowed funds because it is on record that the entire funds borrowed were utilised for acquisition of shares by the assessee in the company. In fact, in our view, assessee would be entitled to deduction of interest under Section 36(1)(iii) of the Act on borrowed funds utilised for the acquisition of shares only if shares are held as stock in trade which arises only if the assessee is engaged in trading in shares. So far as acquisition of shares is in the form of investment and the only benefit assessee derived is dividend income which is not assessable under the Act, the disallowance under Section 14A is squarely attracted and the Assessing Officer, in our view, rightly disallowed the claim. As already pointed out, the Calcutta High Court decision which pertains to the period prior to introduction of Section 14A, has no application. The decision of the Supreme Court also does not apply because in this case apart from investment in shares of the company, there is nothing to indicate that the assessee's business was fully linked with the business of the leasing company or that assessee's business is solely dependent on the business of the leasing company. In fact, the whole transaction was a total fiasco in as much as, as against Rs.17,44,310/- paid towards interest on borrowed funds serviced at the rate of interest of 24% p.a., the dividend income received by the assessee during the previous year was a meager sum of Rs.3 lakhs. This only shows that the business carried on by the leasing company was not very substantial to justify the assessee's investment through borrowed funds. Therefore, in our view, the principle of commercial expediency gone into by the Supreme Court does not apply to the facts of this case. Therefore, we hold that the Tribunal in principle

rightly held that the utilisation of borrowed funds for acquisition of shares will not entitle the assessee for claiming deduction of interest paid on such borrowed funds. However, we hold that the Tribunal was not justified in allowing the claim in excess of Rs.2 lakhs. For the same reasoning applied by the Tribunal, the assessee is not entitled to deduction of any amount towards interest paid on funds borrowed by way of fixed deposits taken for acquisition of shares in the company, which helped the assessee only to earn some dividend. Consequently we allow the appeal by reversing the order of the Tribunal and by restoring the disallowance confirmed in first appeal."

36. As held by the Hon. Jurisdictional High Court in the case of Godrej and Boyee Manufacturing co. ltd Mumbai (supra), section 14A is implicit within it a notion of apportionment in the cases where the expenditure is incurred for the composite/indivisible business which receives taxable and non-taxable income. However, the principle of apportionment is applicable only in the cases where it is not possible to determine the actual expenditure incurred "in relation to" the income not forming the part of the total income. But when it is possible to determine the actual expenditure "in relation to" the exempt income or no expenditure has been incurred "in relation to" the exempt income then the principle of apportionment embedded in section 14A has not application.

37. Even otherwise, the AO has disallowed the interest expenditure on the borrowed funds treating as proportionately used for the investment purposes and not for the reason as used in trading purposes. As evident from the assessment order that the very basis of disallowances is borrowed funds used for investment purposes and estimated by the AO in proportion of borrowed fund to the total fund available. Whereas the dividend income is claimed on the shares purchased for trading purposes and held as stock-in-trade then the very basis of disallowance by the AO is incorrect, highly improper and inconsistent to the uncontraverted factual claim. It is pertinent to note that the reason for disallowance is dividend income which is not forming the part of the total income and the basis of apportionment of the expenditure is investment. Thus, when the dividend income is not on the shares purchased for investment and the dividend was directly credited in to the D-mat account of the assessee and the AO has not disputed this factual claim of the assessee then the action of the AO in adopting the basis of apportionment is not sustainable and contrary to the facts as well as law. Moreover the A.O. has not disputed the fact that the assessee was having its own funds of Rs.27,94,34,833 and the investment is Rs..27,06,64,720/-. Therefore, even if the own funds and interest bearing funds are put into the common pool the

investment is always treated from own capital funds available and the loan and other interest bearing funds are used for working capital. Thus we find force in the contention of the assessee was that the investment has been made only to the extent of their own funds. More important to note that the assessee declared short term as well as the long term capital gain from investment then the question of disallowance u/s 14A regarding the interest expenditure on borrowed funds if any utilized for investment purposes does not arise specifically when no dividend income is earned on the shares purchase for investment.

38. Now we take up the issue of disallowance of administrative expenses u/s 14A :

The AO disallowed the administrative expenditures on the basis of the ratio of the taxable income and dividend income. At the outset the basis of apportionment is absolutely wrong, unreasonable and inappropriate because the expenditure does not depend on the profit or loss arising from the business activity. It is to be noted that if the basis of apportionment of expenditure is taken as income than in case of no income or loss no expenditure can be assigned to the said activity. Therefore the proper and reasonable basis should be the turnover or volume of transaction, frequency and nature of the

transaction/activity. In case of transaction of purchase and sale of share and securities the reasonable basis for apportionment of the administrative expenditure among the different activities should be the volume and nature of the transaction under different activities of business. There cannot be a parity or equal basis for apportionment of the administrative expenses between the delivery based transaction and non-delivery based transaction as well as trading and investment activities. Undisputedly the labour hours and other overhead expenses will be less in case of non-delivery based transaction of purchase and sale of shares & securities in comparison to the delivery based transaction. Similarly in case of collection of dividend through cheques or vouchers will costs more than direct credit in d-mat account. It is undisputable fact that the dividend was directly credited in the D-mat account. Secondly, the dividend income is on the shares held for trading purposes. Moreover, the AO has not given any finding that a particular expenditure is "in relation to" the dividend income. In the case of CIT v. General Insurance Corp. reported in 254 ITR 203. The Hon. Jurisdictional High Court has held that the expenditure incurred on account for salary paid to staff, stamp duty, transfer fee and safe custody charges are not directly relatable to the earning of the dividend and could not be

deduced from the dividend income for the purpose of allowing deduction u/s 80M. Accordingly, in view of the decision of Hon'ble jurisdictional High Court in case of Godrej and Boyce Mfg co. ltd V/s Dy CIT (supra) the A.O. is directed to reconsider and decide the issue in the light of above observations regarding reasonable basis. Needless to say the assessee be given appropriate opportunity of hearing before passing the order on the issue.

39. In view of the above discussion, ground regarding applicability of Rule 8D, we decide that Rule 8D is not applicable to the present assessment year hence allowed. Regarding the issue of disallowance of interest expenditure u/s 14A is allowed in favour of the assessee and expenditure u/s 14A, in view of the decision of the Hon. jurisdictional High Court in the case of Godrej and Boyee Manufacturing co. ltd (supra), we restore this issue to the file of AO for fresh consideration and adjudication. The appeal of the assessee is partly allowed for statistical purposes.

40. In the result, the appeal of the assessee is partly allowed and partly allowed for statistical purposes.

Pronounced in the open court on 10.11.2010

Sd	sd
(R. K. PANDA)	(VIJAY PAL RAO)
ACCOUNTANT MEMBER	JUDICIAL MEMBER

Mumbai, Dated 10 th Nov 2010
SRL:201010

copy to:

1. Appellant
2. Respondent
3. CIT Concerned
4. CIT(A) concerned
5. DR concerned Bench

BY ORDER

True copy

ASSTT. REGISTRAR, ITAT, MUMBAI