

IN THE INCOME TAX APPELLATE TRIBUNAL
“B” BENCH : BANGALORE

BEFORE SHRI N.V. VASUDEVAN, JUDICIAL MEMBER
AND SHRI S. RIFAUR RAHMAN, ACCOUNTANT MEMBER

ITA No.1099/Bang/2012
Assessment year : 2008-09

Hind High Vaccum Company (P) Ltd., No.17, I Phase, Peenya Industrial Area, Bengaluru – 560 058. PAN : AABCH 1227L	Vs.	The Assistant Commissioner of Income Tax, Circle 11(4), Bengaluru.
APPELLANT		RESPONDENT

Appellant by	:	Shri Mukesh Kumar Jain, CA
Respondent by	:	Dr. P.K. Srihari, Addl. CIT(DR)

Date of hearing	:	31.08.2015
Date of Pronouncement	:	04.09.2015

ORDER

Per N.V. Vasudevan, Judicial Member

This appeal by the assessee is against the order dated 12.1.2012 of the CIT(Appeals)-I, Bengaluru relating to assessment year 2008-09.

2. The only issue that arises for consideration in this appeal is as to, whether the disallowance made by the Assessing Officer and confirmed by the CIT(Appeals) of expenses incurred in earning tax-free income invoking

provisions of section 14A of the Income-tax Act, 1961 [“the Act”] r.w. Rule 8D(2) of the Income-tax Rules [“the Rules”] can be sustained.

3. The factual background of the case is as follows. The assessee is a company engaged in the business of manufacture of vaccum systems, pumps, watch crystals, filters and optical counting. It is not in dispute that during the previous year, the assessee earned divided income of Rs.9,728 which was exempt u/s. 10(35) of the Act. In view of the provisions of section 14A of the Act which provides that any expenses incurred in earning income which does not form part of total income should not be allowed as a deduction, while computing total income of an assessee, the Assessing Officer called upon the assessee to explain the expenditure incurred for earning tax-free dividend income. The assessee, in reply, submitted that no expenditure was incurred for earning tax-free income. The AO, however, was of the view that it is not possible to earn income without incurring any expenditure. Invoking the provisions of section 14A of the Act r.w. Rule 8D(2)(ii) & (iii) of the Rules, the AO disallowed a sum of Rs.46,62,647 as follows:-

“The expenses related to exempt income in this case are disallowed as discussed further.

(a) As per Rule 8D 2 (i) : The assessee company has not incurred any direct expenditure to earn the dividend income.

(b) As per Rule 8D 2 (ii): The assessee company has debited an interest expenditure of Rs.2,33,64,542 in its books. (A)

Average value of investment =	12,03,34,866	(B)
Average of Assets =	69,23,38,631	(C)
$\frac{A \times B}{C}$	= 40,60,973	

(c) As per Rule 8D 2 (iii)

$$\begin{aligned} 0.5\% \text{ of average investment} &= 12,03,34,866 \times 0.50\% \\ &= 6,01,674 \end{aligned}$$

$$\text{Rule 8 D2(ii) + Rule 8D2(iii)} = \mathbf{46,62,647}$$

Therefore Rs.46,62,647 is added back to the income of the assessee u/s 14A of IT Act, 1961.”

4. Before the CIT(Appeals), the assessee submitted as follows:-

On Disallowance of interest expenses invoking Rule 8D(2)(ii) of the Rules:

That the Assessee had incurred interest expense against the business following aspects before CIT(A):

i) The Interest debited to profit & loss account of Rs.2,33,64,542/- which was considered by the assessing officer for disallowance under Rule 8D of the Rules is the interest incurred by the assessee on account of credit facilities and other lease obligations.

ii) Term loan / period loan granted by banks are with prior conditions and are disbursed by banks to the vendor directly. So question of investing such amount in investment which are likely to yield tax free income, does not arise for consideration at all.

iii) Cash credit facilities granted by banks are also with prior conditions that such amounts are utilized for business working capital and not for investments. Cash credit limits granted and used, are monitored so that the limit is not utilized for purposes other than mandated. Copies of the sanction letters of the bank were also filed before CIT(A).

iv) The Assessee also pointed out that in the auditors' report there was no adverse comment on the usage of the interest bearing borrowed funds.

v) The Assessee also gave an extract of the own funds [as at 31st March 2008] of the Assessee for the year under consideration.

Share capital	-	2,58,36,420
Reserves & surplus	-	1,1,71,75,150
Total	-	1,4,30,11,570

vi) The Assessee further pointed out that M/s Aureos India Trustees Private Limited had invested Rs. 30,00,00,000 by way of compulsorily convertible debentures in the company in the financial year 2006-07 [AY 2007-08] which the Assessee invested in mutual funds. These compulsory convertible debentures **do not carry any interest**.

vii) The Assessee pointed out that it had primarily invested in mutual funds from the money received through issue of compulsorily convertible debentures as stated above. The cash flow statement of usage of the 30 Crores was also filed before the CIT(A).

viii) The Assessee also furnished the following table showing details of borrowings and investment to substantiate the claim of the Assessee that borrowed funds on which interest expenditure was incurred was not used for making investments which are likely to yield tax free dividend income, necessitating invoking Sec.14A of the Act:

Financial year	Borrowings from banks	Compulsorily Convertible Debentures	Investment in mutual funds	Investment in building	Investment in machinery	Investment in subsidiary
31/3/2006	118,234,771	-	-	-	-	-
31/3/2007	145,515,128	300,000,000	130,240,687	-	62,270,612	-
31/3/2008	328,751,010	300,000,000	110,105,846	-	195,440,732	-
31/3/2009	368,389,285	300,000,000	-	-	195,440,732	100,000,000

ix) The Assessee pointed out that from the above table, it would be evident that interest debited to profit & loss account of Rs. 2,33,64,542/- was towards earning of business income only and not towards earning of dividend income.

On disallowance under rule 8D(2)(iii) of the Rules:

The Assessee also pointed out that Rule 8D (2) (iii) states that an amount equal to 0.5% 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.

The Assessee submitted that in the present case, the assessing officer has applied the simple average of the value of the Investment. Application of the simple average in some cases may give absurd results. For example, if the investment at the beginning date is 10 Crores and the said investment are redeemed on completion of one month the average cannot be said to be 5 Crores for the year. If the weighted average based on time is computed, the value would be around 82 Lacs. [10 Crores*30/365 days]. In another instance, if opening balance is zero and closing balance is zero, the net result will be zero when the simple average method is applied. In such an instance, if the investments of the Interim period are not considered then the result obtained again would be absurd.

The Assessee also gave a computation sheet applying weighted average based on time and by doing so the disallowance would work out to Rs. 90,49,796/-.

The Assessee thus pleaded that application of Rule 8D(2) clause (ii) & (iii) as done by the AO was erroneous.

5. The CIT(Appeals), however, did not agree with the submissions of the assessee. He was of the view that assessee failed to establish nexus between the borrowed funds on which interest was paid and its use for the business of the assessee. He also observed that if assessee kept both borrowed funds and own funds in the same bank account and withdrew the same for making investments which would yield tax-free income. According to him, in those circumstances one cannot say with certainty that

borrowed funds on which interest had been paid had not been utilised for making investments which are likely to yield tax free income. The CIT(Appeals) followed his own decision rendered in the case of *Jupiter Capital Pvt. Ltd. in ITA No.168/AC-11(5)/A-I/10-11 dated 30.11.2011*, wherein the CIT(A) had concluded that disallowance under Rule 8D is mandatory on and from AY 2008-09 from which Assessment Year Rule 8D was applicable. The CIT(A) also held that once there is tax-free dividend, then disallowance u/s. 14A has to be made of expenses incurred in earning tax-free income irrespective of the quantum of the expenditure that has to be disallowed.

6. Aggrieved by the order of CIT(Appeals), the assessee has preferred the present appeal before the Tribunal.

7. The submissions made by the Id. counsel for the assessee are almost identical to the submissions as were made by the assessee before the CIT(Appeals). In particular, it was submitted before that the quantum of exempt income in the form of dividend earned by the assessee was only a sum of Rs.9,728, whereas disallowance made by the AO invoking the provisions of section 14A of the Act was a sum of Rs.46,62,647. The Id. counsel for the assessee brought to our notice the decision of the Hon'ble Delhi High court in the case of *Joint Investments Pvt. Ltd. v. CIT, ITA No.117/2015 dated 25.2.2015*, wherein the Hon'ble High Court expressed the view that disallowance u/s. 14A of the Act cannot, in any case, exceed

the dividend income. Following were the observations that were brought to our notice:-

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

8. Reference was also made to the decision of ITAT Mumbai Bench in *Daga Global Chemicals Pvt. Ltd. v. ACIT, ITA No.5592/Mum/2012, dated 1.1.2015*, in which the Tribunal was of the view that disallowance u/s. 14A cannot exceed the exempt income.

9. The Id. DR placed reliance on the order of CIT(Appeals). It was also submitted by him that evidence on record does not show as to how the borrowed funds were not used for making investments which yield tax free income.

10. We have given a careful consideration to the rival submissions. In the course of hearing, a query was raised by the Bench as to whether the Balance Sheet as on 31.3.2007 and 31.3.2008 were filed to show that borrowed funds were not used for the purpose of investments which yielded tax-free income. The Id. counsel for the assessee has not filed the required details before the Tribunal. In our view, for the purpose of deciding the disallowance under section 14A r.w. Rule 8D(2)(ii), those details will be very material. We are of the view that if the stand taken by the assessee on the disallowance of interest expenses under Rule 8D(2)(ii) of the Rules is factually correct, then no disallowance of interest expenses can be made. We, however, find that the required details have not been filed by the assessee before us. In such circumstances, we are of the view that it would be just and fair to set aside the order of the CIT(Appeals) on this issue and remand the question of disallowance of interest expenses under Rule 8D(2)(ii) to the Assessing Officer for fresh consideration with a direction to the assessee to furnish the required details to substantiate its claim as made before the CIT(Appeals).

11. As far as disallowance under Rule 8D(2)(iii) is concerned, the assessee has not shown as to what is the expenditure to be disallowed. The assessee's only plea before the CIT(A) was that weighted average based on time (no. of days) in which investments were made should be considered. As rightly contended by the Id. DR, the above stand of the assessee cannot be sustained in view of the clear mandate of Rule

8D(2)(iii) of the Rules, which refers to only the average value of investments as appearing in the Balance Sheet of the assessee as on the first and last day of the previous year. One cannot travel beyond the language of Rule 8D(2)(iii) of the Rules. In the absence of any other plea by the assessee in this regard, the disallowance has to be sustained. However, we find that the Hon'ble Delhi High Court in *Joint Investments Pvt. Ltd. (supra)* has held that disallowance u/s. 14A of the Act cannot be in excess of the tax exempt income. Following the aforesaid decision, we direct the AO to restrict the disallowance to income that is exempt in the set aside proceedings under Rule 8D(2)(iii) of the Rules, after complying with the directions with regard to disallowance of interest expenses under Rule 8D(2)(ii) of the Rules.

12. In the result, the appeal of the assessee is accordingly treated as partly allowed for statistical purposes.

Pronounced in the open court on this 4th day of September, 2015.

Sd/-

(S. RIFAUR RAHMAN)
Accountant Member

Sd/-

(N.V. VASUDEVAN)
Judicial Member

Bangalore,
Dated, the 4th September, 2015.

/D S/

Copy to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.
6. Guard file

By order

Assistant Registrar /
Senior Private Secretary
ITAT, Bangalore.