IN THE INCOME TAX APPELLATE TRIBUNAL
COCHIN BENCH, COCHIN

Before Shri George George K, JM & Shri Manjunatha G, AM

ITA No.506/Coch/2016 : Asst.Year 2009-2010

The Income Tax Officer Corporate Ward 1(4) Kochi.	Vs.	M/s.Kerala Ayurveda Ltd. Athani P.O. Aluva – 683 583. **PAN : AABCK4228Q.**
(Appellant)		(Respondent)

Appellant by : Sri. A.Dhanaraj, Sr.DR
Respondent by : Sri. Mathew Joseph, CA

Date of Hearing : 13.12.2017		**Date of Pronouncement : 14.12.2017**

O R D E R

Per Manjunatha G, AM

This appeal filed by the Revenue is directed against the order of the Commissioner of Income-tax (A)-I, Cochin, dated 30th September, 2016 and it pertains to assessment year 2009-2010.

2. The Revenue has raised the following grounds of appeal:-

"A. The order of the Commissioner of Income tax (Appeals)-I, Kochi, in appeal No: ITA-84/R-1/E/CIT(A)-II/2011-2012 dated 30.09.2016, is opposed to law, weight of evidence, facts and circumstances of the case.

In the facts and circumstances of the case –

1. the learned Commissioner of Income Tax (Appeals) erred in holding that the disallowance u/s 14A of Rs.25,65,496/- is unjustified.

1.2 the learned Commissioner of Income Tax (Appeals)-I, Kochi is not justified in applying the judgment of the Hon'ble Supreme Court in the case of CIT vs. Walfort Share & Stock Brokers (2010) 326 ITR 01 (SC) to the facts of the present case.

1.3 the learned Commissioner of Income Tax (Appeals)-I, Kochi is erred in stating that the CBDT Notification No.A.50050/112/2015-Ad.I dated 27 October, 2015 is an indicative for deleting the disallowance u/s 14A.

1.4 It is prayed that the order of the Commissioner of Income-tax (Appeals) deleting the disallowance u/s 14A be reversed and that of the Assessing Officer restored.

2. the learned Commissioner of Income Tax (Appeals) is not justified in deleting the addition of Rs.73,71,048/- made on account of amortization of software expenditure.

2.1 the learned Commissioner of Income Tax (Appeals)-I, Kochi ought to have restricted the depreciation on software expenditure to be capitalized by taking into account the disallowance of Rs.73,71,048/- deleted.

2.2 the learned Commissioner of Income Tax (Appeals)-I, Kochi is not correct to allow depreciation on software expenditure totaling to Rs.3,93,87,415/-.

2.3 the learned Commissioner of Income Tax (Appeals)-I, Kochi ought to have considered software expenditure at Rs.3,68,55,240/- instead of Rs.3,93,87,415/- while directing to allow depreciation @ 60%, by taking into account 1/5th

amortization of Rs.73,71,048/- debited by the company to its P&L Account.

B. For these and other grounds that may be urged at the time of hearing, it is requested that the order of the Commissioner of Income Tax (Appeals) may be set aside and that of the Assessing Officer restored."

3. The brief facts of the case are that the assessee-company is engaged in the business of manufacturing Ayurvedic drugs and pharmaceuticals, filed its return for the assessment year 2009-2010 on 29.09.2016 declaring loss of Rs.4,18,20,104. The assessment was completed u/s 143(3) on 14.11.2011 determining the total loss at Rs.2,28,44,227, inter alia, making additions towards disallowance of expenditure incurred in relation to exempt income u/s 14A and disallowance of amortization of software development expenditure of Rs.73,71,048.

4. Aggrieved by the assessment order, the assessee preferred appeal before the CIT(A). Before the CIT(A), the assessee has filed elaborate written submissions to challenge the disallowance of expenditure incurred in relation to exempt income, on the ground that the A.O. was erred in disallowance interest expenditure under Rule 8D(2)(ii) without appreciating the fact that the assessee has invested in shares of subsidiary companies out of its own funds and no interest bearing fund has been diverted. Insofar as the disallowance of amortization of software development expenses, the assessee has submitted that the A.O. has erred in disallowing amortization software expenses without appreciating the fact

that the assessee has developed in-house software and the life of the software is expected to go five years. Therefore, the assessee has rightly amortized 1/5th software development expenses. The CIT(A) after considering the relevant submission of the assessee and relying upon plethora of judicial pronouncements including the decision of the Hon'ble Supreme Court in the case of *CIT v. Walfort Share & Stock Brokers [(2010) 326 ITR 1 (SC)]* deleted the addition made by the A.O. towards disallowance of expenditure incurred in relation to exempt income u/s 14A, by holding that the assessee has demonstrated with clear evidences that interest paid to term loan and working capital loan have used for acquisition of capital asset as well as working capital requirements and further no part of interest bearing funds has been invested in investments yielding exempt income. Insofar as the disallowance made by the A.O. towards amortization of software expenses, the CIT(A) deleted the additions made by the A.O. on the ground that this amortization was done because the life of the software was expected to be more than five years and expected to create benefits of enduring nature. The CIT(A) further allowed depreciation at the rate of 60% on remaining amount on the ground that the assessee has omitted to claim depreciation on remaining amount of software expenditure. The CIT(A) further observed that the assessee has demonstrated with evidences that it has developed in-house software and also capitalized the software and put to use for more than 180 days. Accordingly, the assessee is eligible for depreciation at the

rate of 60% as applicable to software and related assets. Aggrieved by the CIT(A)'s order, the Revenue is in appeal before us.

5. The first issue which came up for consideration from the Revenue's appeal is disallowance of expenditure incurred in relation to exempt income u/s 14A r.w.r. 8D(2)(ii) of the Income-tax Rules, 1962.

6. The learned Departmental Representative submitted that the learned CIT(A) was erred in deleting the addition made by the A.O. by applying the judgment of the Hon'ble Supreme Court in the case of *CIT v. Walfort Share & Stock Brokers (supra).* The issue before the Hon'ble Supreme Court is whether disallowance worked out by the A.O. in relation to exempt income u/s 14A is justified when the assessee has invested in shares and held it as stock-in-trade. In this case, the assessee has made investments in shares and securities which yield exempt income. Therefore, the A.O. was right in invoking the provisions of section 14A r.w.s. 8D.

7. The learned AR for the assessee, on the other hand, strongly supporting the order of the CIT(A) submitted that the CIT(A) was right in deleting the additions made by the A.O. as the assessee has demonstrated with evidences that no part of interest bearing funds has been used in investment which yield exempt income. The AR further submitted that the assessee has made investments in group companies out of its own share premium and share capital. The Assessing Officer

disallowed a portion of the interest alleging that the loan funds were used for investment. Interest expenses comprises of interest on term loan and cash credit and such loans have been used for acquisition of fixed assets as well as working capital requirements. Therefore, there is no reason for A.O. to disallow interest by invoking Rule 8D(2)(ii). Insofar as the disallowance of 0.5% of average value of investment towards expenditure is concerned, the A.O. without considering any nexus between the expenditure incurred in relation to exempt income, disallowed 0.5% of average value of investment, despite the fact that the assessee has proved beyond doubt that there is no specific expenditure incurred to earn exempt income.

8. We have heard the rival submission and considered the material on record. The A.O. disallowed the expenditure in relation to exempt income u/s 14A by invoking Rule 8D(2)(ii) of the Income-tax Rules, 1962. According to the A.O., from the assessment year 2008-2009 onwards disallowance contemplated u/s 14A is mandatory in nature and also to work out such disallowances a prescribed methodology rule provided under Rule 8D of the Income-tax Rules, 1962. It is the contention of the assessee that its investments are in subsidiary companies for the strategic investment to hold control over group companies, but not to earn any exempt income. The assessee further contended that these investments are fully come out of its own funds in the nature of share capital and share premium and no part of interest

bearing fund has been used to make investments in subsidiary companies.

9. Having considered both the sides, we find merits in the contention of the assessee for the reason that the assessee has demonstrated with evidences, no part of interest bearing funds has been used to make investment in shares which yield exempt income. The assessee has furnished details to prove availability of its own funds and also proved beyond doubt the term loan and working capital loan have been used for acquisition of fixed assets as well as working capital requirements of the assessee. Therefore, we are of the view that there is no reason for the A.O. to disallow the interest paid on term loan and working capital loan. The CIT(A), after considering the relevant submission, has rightly deleted the addition made by the A.O. towards disallowance of interest under Rule 8D(2)(ii).

10. Insofar as the disallowance of administrative and general expenses under Rule 8D(2)(iii) is concerned, the assessee claims that, it did not incur any expenditure for earning exempt income. The assessee further contended that the investments are made in group companies which are invested in earlier years. Though it has incurred certain common expenses in the nature of general administrative expenses, no specific expenditure has been incurred to earn exempt income. We do not find any merit in the arguments of the assessee for the reason that when there is no substantial investments in shares which yield exempt income, the

possibility of incurring certain common expenditure attributable to investment cannot be ruled out. Though the assessee claims to have not incurred any specific expenditure, it is abundantly clear that the assessee has incurred various administrative and general expenses, which are in common nature. Therefore, we are of view that the A.O. was right in computing disallowance towards expenses incurred in relation to exempt income. However, the disallowances contemplated u/s 14A can in any way swallow the entire exempt income earned by the assessee. The window for disallowance for invoking the provisions of section 14A is only to the extent of disallowing expenditure incurred by the assessee in relation to the exempt income. This proportion or portion of the tax exempt income surely cannot swallow the entire amount. In this case, admittedly, the assessee has earned dividend income of Rs.4,000 from investment in shares of Canara Bank, whereas the A.O. has determined disallowance of expenditure at Rs.3,23,520. Therefore, we are of the view that the disallowance determined u/s 14A cannot exceed the exempt income. This legal proposition is supported by the decision of the Hon'ble Delhi High Court in the case of *Joint Investment Private Limited v. CIT [(2015) 372 ITR 694 (Del.)]*, wherein it was observed as under:-

> *"9. In the present case, the O has not firstly disclosed why the appellant / assessee's claim for attributing Rs.2,97,440 as a disallowance under s.14A had to be rejected. Taikisha Engg. India Ltd. (supra) 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 Tribunal. The third, and in the opinion of the 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 per cent of that sum, i.e., Rs.52,56,197. By no stretch of imagination can s.14A or r.8D be interpreted so as to mean that the entire tax exempt income is to be disallowed. The window for disallowance is indicated in s.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."

11. In view of the matter and considering the ratio of the case law discussed above, we are of the considered view that disallowance as contemplated u/s 14A of the Act cannot exceed exempt income. Therefore, we direct the A.O. to restrict the disallowance worked out under Rule 8D(2)(iii) to the extent of exempt income earned by the assessee for the relevant period.

12. The next issue came up for consideration is deletion of additions made by the A.O. towards disallowance of amortization of software development expenses. The A.O. had disallowed amortization of software development expenses on the ground that software development expenses is a capital asset, which is to be included along with computers in the block of assets for claiming depreciation. The learned AR for

the assessee at the time of hearing submitted that the ground raised by the Revenue challenging deletion made by the CIT(A) towards disallowance of amortization of software expenses becomes infructuous as learned CIT(A) has withdrawn relief allowed towards disallowance of amortization of software expenses vide his rectification order u/s 154 r.w.s. 253 of the Income-tax Act, 1961. The learned AR further submitted that in the appellate proceedings the learned CIT(A) has allowed amortization of preliminary expenses claimed by the assessee in addition to directing the A.O. to allow 60% depreciation on software expenses. The assessee has filed a rectification application u/s 154 seeking rectification of deletion made by the A.O. towards disallowance of amortization of software expenses as the CIT(A) has allowed the claim of the assessee with regard to depreciation on total block of assets. The learned CIT(A) has rectified the said mistake and hence the ground raised by the Revenue challenging the deletion made by the CIT(A) becomes infructuous, hence not maintainable. We find that the issue of amortization of software development expenses and depreciation on capital expenditure has been dealt by the CIT(A) in his appellate order and allowed relief to the assessee on both the counts. We further noted that the CIT(A) in his rectification order dated 09.12.2016 rectifying the said mistake had allowed relief only in respect of claim of depreciation on software expenditure and confirmed the addition made by the A.O. towards disallowance of amortization of software expenditure. Therefore, we are of the view that the ground raised by the

Revenue challenging deletion made by the CIT(A) becomes infructuous and hence the same is dismissed.

13. In the result, the appeal filed by the Revenue is partly allowed.

Order pronounced on this 14th day of December, 2017.

Sd/-	Sd/-
(George George K.)	**(Manjunatha G.)**
JUDICIAL MEMBER	**ACCOUNTANT MEMBER**

Cochin ; Dated : 14th December, 2017.
Devdas*

Copy of the Order forwarded to :

1. The Appellant
2. The Respondent.
3. The CIT, Kochi.
4. CIT(A)-I, Kochi.
5. DR, ITAT, Cochin
6. Guard file.

By order

(Asstt. Registrar)
ITAT, Cochin