

**IN THE INCOME TAX APPELLATE TRIBUNAL
'C' BENCH : BANGALORE**

**BEFORE SHRI CHANDRA POOJARI, ACCOUNTANT MEMBER
AND
SMT BEENA PILLAI, JUDICIAL MEMBER**

ITA No. 347/Bang/2023
Assessment year : 2013-14

Shri Hemanshu Mahendra Shah, No.51, 2 nd Main Road, Sheshadripuram, Bangalore- 560 020. PAN – AAITS 9873 R	Vs.	The Dy. Commissioner of Income-tax, Circle-2(2)(1), Bangalore
APPELLANT		RESPONDENT

Assessee by	:	Shri Sudheendra B.R, Advocate
Revenue by	:	Smt. Priyadarshini Besaganni, CIT (DR)

Date of hearing	:	15.06.2023
Date of Pronouncement	:	22.06.2023

ORDER

PER BEENA PILLAI, JUDICIAL MEMBER

Present appeal is filed by the assessee against the order dated 01/03/2023 passed by the NFAC for the assessment year 2017-18 on following grounds of appeal:-

“1. *General ground:*

1.1. The learned Commissioner of Income Tax (Appeals), (hereinafter referred to as CIT(A) for short) has erred in passing the order under section 250 in the manner passed by him. The order so passed to the extent prejudicial to the appellant is bad in law and liable to be quashed.

2. Ground relating to disallowance of interest expenditure under section 36(1)(iii)

2.1. The learned CIT(A) has erred in confirming the disallowance under section 36(1)(iii) to the extent of Rs. 40,68,000. On facts and circumstances of the case and law applicable, the disallowance sustained amounting to Rs. 40,68,000 should be deleted.

3. Ground relating to disallowance under section 14A

3.1. The learned CIT(A) has erred in confirming the disallowance under section 14A read with rule 8D to the extent of Rs. 3,08,579. On facts and circumstances of the case and law applicable, the disallowance of Rs. 3,08,579 should be fully deleted.

4. Levy of interest under section 234B

4.1. The levy of interest under section 234B is bad in law and liable to be quashed.

5. Prayer:

5.1. Based on the above grounds and other grounds adduced at the time of hearing, the appellant prays that the order passed under section 250 to the extent prejudicial to the appellant quashed or in alternative the above grounds and relief prayed thereof be allowed.”

2. The brief facts of the case that the assessee is an individual and filed his return of income declaring Nil income on 18/09/2014. The return was processed u/s 143(1) of the Act by CPC and subsequently the case was selected for scrutiny under CASS. Statutory notices u/s 143(2) and 142(1) of the Act were issued. In response to which, the representative of assessee appeared and filed the requested details as called for. The Ld.AO from the balance sheet found that the assessee has availed unsecured loans of Rs.22,92,70,601/- and has paid interest of Rs.1,58,45,630/-. The Ld.AO also noted that the assessee has received interest of Rs.44,19,661/- that was credited to the P&L account. The assessee also shown receipt of interest on capital from partnership firm M/s Urban Heights amounting to Rs.12,18,955/- in the P&L account. The AO called for details of interest charged and paid on loans availed.

3. It is the observation of the Id.CIT(A) that the assessee did not file these details and AO was therefore of the view that assessee has invested borrowed funds in other assets, capital in firms, proprietorship concern etc. And, therefore, the interest paid on borrowed funds has been disallowed as deduction. The Id.AO hence, disallowed the excess interest paid over the interest received amounting to Rs.1,02,07,014/-

3.1 The Id.AO further noted that the assessee has made huge investment in equity shares and capital in firms in which, he was a partners but he did not make any disallowance u/s 14A of the Act. The AO thus computed disallowance u/s 14A of the Act read with Rule 8D(2)(ii) & (iii) amounting to Rs.95,27,092/-

4. Aggrieved by the order of the AO, the assessee filed appeal before the Id.CIT(A). The Id.CIT(A) after considering various submissions of the assessee restricted it to Rs.40,68,000/- . The Id.CIT(A) observed as under:--

“7.1 The matter has been carefully considered. The thrust of the assessee's argument is that no disallowance of interest could be made merely because the interest earned is less than the Interest paid. The 8886886e has further stated that both didets of the transaction, i.e borrowing money as well as advancing money on interest are part of business activity and therefore, the AO has drawn an erroneous conclusion. It is seen that the AO has disallowed the excess of interest expense over interest income. which in my view is a very simplistic approach, made without examining facts regarding loans borrowed and loans advanced. The AO attempted to examine whether funds borrowed by the assessee have been diverted for non-business purposes and if interest bearing funds have been utilised for advancing loans without interest. According to the AO, the assessee did not furnish details of loans borrowed along with interest rate thereon, as also loans advanced with interest charged thereon. The AO therefore simply disallowed the excess of interest debited over interest earned. The issue at hand,

simpliciter, is the applicability of sec 36(1)(iii), as only interest on borrowed funds utilised for purpose of business can be allowed as a deduction u/s 36(1)(iii). If any part of borrowed funds has been diverted for non-business purpose, the interest on that part is to be disallowed. I have examined the balance sheet, P&L A/c and the computation of total income of the assessee and find that the capital account of the assessee is overdrawn and is a negative (-) Rs 177.61 lakhs as on 31/03/2013. The opening balance in the capital account as on 01/04/2012 was overdrawn (-) Rs 86.31 lakhs which rose to (-) Rs 177.61 lakhs, inter-alia. due to the current year business loss of Rs 93.97 lakhs. The P&L A/c reveals that the interest debited as well as the interest earned by the assessee is classified under head Profits & gains of business. One needs to examine the utilization of interest-bearing borrowed funds. The B/S reveals that the capital account is overdrawn (-) Rs 177.61 lakhs and the assessee has borrowed funds of Rs 2292.70 lakhs, meaning thereby that borrowed funds are the only source of funds and the assessee does not have own funds/capital. The other items on the liability side are small amounts such as Sundry Creditor Rs 40,715 and current liabilities Rs 3.6 lakhs. On the asset side, the application of funds is towards fixed assets Rs 19.91 lakhs, other assets Rs 87.31 lakhs, current assets (which is entirely investment in capital of partnership firms where assessee is a partner, and capital in proprietorship concern) Rs 1359.20 lakhs, investment in shares of listed companies Rs 76,58 lakhs, deposits Rs 3.27 lakhs, loans and advances Rs 542.54 lakhs and cash and bank balances Rs 6.41 and Rs 23.85 lakhs. Interest is debited on borrowed funds which are part of Rs 2292.70 lakhs and interest is earned on loans and advances which are part of Rs 542.54 lakhs. I specifically requested the assessee to furnish details of borrowed funds, as well as loans advanced along with rate of interest paid/charged, interest debited/earned etc. In response, the assessee has tiled a detailed paper book inter-alia listing out details of borrowed funds, interest paid along with rate, as well as interest earned with rate etc. It is seen that out of total borrowing of Rs 2292.70 lakhs, Rs 535.16 lakhs are interest free loans, while Rs 1757.53 lakhs are interest bearing loans. Out of 26 such loans taken, most carry an interest of 12%, but there is one loan each of 9% & 13% and 2 loans of 15%. This means that out of total borrowings, 23.34% (Rs 535.16/Rs 2292.7 lakhs) is interest free, while 76.66% is interest bearing loans.

7.2 Analysis of the asset side reveals that the assessee has advanced loans without interest as well as with interest. The total loans & advances stand at Rs 542.54 lakhs to 18 concerns, out of which interest has been charged on advances to only 4 concerns. The assessee has charged interest of Rs 2.31 lakhs from Arun Talreja, Rs 4.87 lakhs from Hercules Civil Constructions, Rs 3.28 lakhs from R V Harish and Rs 33.71 lakhs from M J Shantaram, totalling to Rs 44.19 lakhs which is duly accounted as business income. No interest has been charged on the other 14 concerns, and the breakup of the principal amounts advanced interest free and interest bearing is Rs 177.41 lakhs & RS 365.12 lakhs respectively. The assessee is charging interest on 67.2% of his advances, while the balance of 32.8% is interest free advances. A further analysis of the asset side reveals that apart from the capital account being overdrawn (-) Rs 177.61 lakhs, the assessee has invested in personal/ non-business assets too such as flats in Diva & Sankeshwar (classified as other assets) Rs 87.31 lakhs. The other assets such as investment in partnership firms, capital of proprietary concern, deposits etc are evidently for business purposes. It thus transpires that the assessee has lent money interest free as well as invested in certain personal assets, and also overdrawn his capital account, meaning thereby that borrowed funds have been diverted for non-business/ personal purposes, thus calling for an in-principle disallowance of interest.

7.3 As the total borrowing of Rs 2292.70 lakhs is the only source of funding, and a majority of it is interest bearing funds, it would be fair to hold that the source of investment in non-business/ personal use/ non-interest-bearing advances, would be in the same proportion as the interest-bearing borrowing. The assessee is maintaining a common hotch potch of funds i.e to say both interest bearing as well as interest free funds are mixed and there is no way to establish a separate cash flow for either, making it impossible to identify the specific source of funds for each asset. This necessitates an aggregator approach, wherein the totality of the balance sheet is taken. The interest-bearing funds constitute 76.66% and interest free funds constitute 23.34% of total borrowing. It would be fair to hold that each asset whether for business purpose or otherwise, has been sourced in the same proportion, i.e 76.66% of each asset is sourced from interest bearing funds, and 23.34% is from interest free funds. This is the only reasonable conclusion to be drawn so as to be fair to the assessee, due to the fact that the only source of funds

with the assessee are borrowed funds and his capital account is overdrawn. The interest free borrowing could be loosely held to be 'own funds' category. As discussed earlier, the non-business/ personal assets are: Overdrawn capital account balance of (-) Rs 177.61 lakhs, Personal assets flats at Diva & Sankeshwar Rs 87.31 lakhs and interest free advances of Rs 177.41 lakhs, totalling to Rs 442.33 lakhs. 76.66% of this is sourced from interest bearing borrowing, i.e Rs 339.09 lakhs. As the borrowing rate is mostly 12%, the disallowance u/s 36(1)(iii) would be 12% of Rs 339.09 lakhs = Rs 40.68 lakhs. This is the correct disallowance of interest to be made for diversion of borrowed funds for non-business purposes. The AO is directed accordingly and the disallowance of Rs 1,02,07,014 .is restricted to Rs 40,68,000. Grounds 1 & 5 are partly allowed.”

5. On the issue of disallowance quantified u/s 14A of the Act, the Id.CIT(A) observed as under:-

“8.3 Let me now examine the facts of the case before me. As discussed in para 7 of this order, investment in shares is Rs 76,58,504 and investment in partnership capital in 6 firms is Rs 9,13,30,409 (investment in proprietorship concern has been excluded). The details of partnership firms and capital invested therein is as follows: Ambience Developers Rs 1,85,67,500, Ambience Projects Rs 13,74,076, Ambience Properties Rs 1,06,62,904, Shah Properties Rs 1,65,82,086, Trisquare Green Projects Rs 3,72,08,364 and Urban Heights Rs 96,83,632. The share of profit from these firms & the dividends received is admittedly exempt in the hands of the assessee. It has to be decided whether any disallowance u/s 14A is called for in the case of the assessee, and the quantum would be a subsequent issue. As discussed in para 8.2 above, the contention of the assessee that sec 14A would not apply to any of his exempt income has been rejected. It is also seen that no disallowance at all has been made or offered by the assessee in his computation of income. It is also evident on facts that the capital account being overdrawn, indicates that he does not have "own funds". I have also proved on facts that the only source of funds are borrowings, 76.6% of which are interest bearing. The contention of the assessee that he has not incurred any expenditure for earning exempt income is thus not acceptable, as it is evident on facts that at least 76.6% of investment yielding tax free income has been sourced out of interest-bearing funds. As discussed earlier in this

order, in view of the assessee maintaining a common hotch potch i.e both interest bearing as well as interest free funds are mixed and there is no way to establish a separate cash flow for either, making it impossible to identify the specific source of funds for each asset, it would be fair to hold that 76.6% of investments are sourced from interest bearing funds. This approach finds approval in the decision of the Hon'ble ITAT Bangalore in the case of Karnataka State Beverages Corpn (2023) 146 taxmann.com 436 wherein it has been held as follows.

10. Learned Counsel for the assessee submitted before us by drawing our attention to page 182 of the assessee's Paper Book which contained the profit and loss account for the year ended 31-3-2009 that the turnover realizations were Rs. 8.22,841.26 lakhs and this was a sufficient source of funds for investments that yielded tax free income. No other material was placed before us nor any explanation except the same explanation as put forth before CIT(A) was made before us. With regard to disallowance under Rule 8D(2)(iii) of the Act, no submissions were made.

11. We have considered the submissions of the learned Counsel for the assessee and are of the view that the explanation given by the assessee before us is not sufficient to avoid the disallowance in terms of Rule 8D(2)(ii) of the Rules. The assessee has to establish by necessary fund flow statements that borrowed funds on which interest paid was not utilized for the purpose of making investments with yielded tax free income. In these circumstances, we are of the view that the disallowance made by the Revenue authorities by invoking the provisions of section 14A of the Act read with rule 8D(2)(ii) and 8D(2)(iii) of the Rules deserves to be upheld and the same is upheld. The grounds of appeal are accordingly dismissed.

In the present facts before me also, borrowed funds being the only source in the hands of the assessee, a disallowance u/s 14A is called for.

8.4 In respect of the quantification, the AO has adopted the whole interest debited for computation u/r 8D(2)(ii). This is clearly incorrect and in light of my decision in para 7 above, only interest on borrowed funds invested in partnership capital and share investment is to be considered. I have already held that 76.6% of these investments are sourced from borrowed funds, which means the interest on 76.6% of Rs 76,58,504 being share investment and Rs 9,13,30.409 being investment in partnership capital in 6 firms is to be considered u/r

8D(2)(ii), which works out to Rs 90,99,060 (12% of 76.6% of 9,89,88,913). However, it is only fair to further reduce the interest already disallowed u/s 36(1)(iii) in grounds 1 & 5 decided above, else it would be a double jeopardy. The AO is therefore directed to consider interest of Rs 50,31,060 (Rs 90,99,060 — Rs 40,68,000) for the purpose of rule 8D(2)(ii). The opening as well as closing balance of investment in shares was Rs 76,58,504, while the opening balance of investment in partnership firms was Rs 5,55,19,613 (as furnished by the assessee in his PB), and closing balance is Rs 9,13,30,409. The opening balance of investment is Rs 6,31,78,117 (Rs 76,58,504 + Rs 5,55,19,613), while the closing balance is Rs 9,89,88,913 (Rs 76,58,504 + Rs 9,13,30,409). Based on the discussion above, the disallowance u/r 8D is worked out as follows. There is no disallowance u/r 8D(2)(i).

u/r 8D(2)(ii)

Investment as on 31/03/2012 Rs 6,31,78,117

Investment as on 31/03/2013 Rs 9,89,88,913

Average Investment Rs 8,10,83,515

Average of total assets Rs 17,67,97,429 (as adopted by AO)

Disallowance = Rs 50,31,060 * Rs 8,10,83,515 / Rs 17,67,97,429

= Rs 23,07,364. u/r 8D(2)(ii)

Disallowance u/r 8D(2)(iii) 0.5% of Rs 8,10,83,515 = Rs 4,05,417

Total disallowance u/r 8D = Rs 27,12,781

However, it has been held in various decisions of the Hon'ble Karnataka High Court that where there is no exempt income, there cannot be any disallowance u/s 14A. (Refer Delhi International Airport Ltd (2022) 138 taxmann.com 541). It has also been held by several other High Courts that the disallowance is to be restricted to the exempt income. Facts indicate that the exempt income for this year is Rs 3,08,579 (Dividend Rs 11,887 & Share of profit Rs 2,96,692) and I am therefore of the view that the disallowance u/s 14A is to be restricted to Rs 3,08,579. The AO is directed accordingly and Ground 8 is partly allowed.”

5.1 The Id.CIT(A), thus restricted the disallowance u/s 14A of the Act to Rs.3,08,579/-. It was also contended by the assessee before the Id.CIT(A) that the interest disallowance has been made u/s 36(1)(ii) as well as u/s 14A of the Act. The Id.CIT(A), thus

reduced only such interest that was disallowed u/s 36(1)(ii) of the Act from the computation under Rule 8D(2)(ii).

Aggrieved by the order of the Id.CIT(A), the assessee is in appeal before this *Tribunal*.

6. The Ld.AR submitted that **Ground No.1** is general in nature and, therefore, do not require any adjudication.

7. **Ground No.2** is raised in respect of disallowance of interest expenditure u/s 36(1)(ii) of the Act. The Ld.AR submitted that the assessee has sufficient funds to cover the investments as per the profit and loss account. It is the submission of the Ld.AR that the principle laid down by the *Hon'ble Bombay High Court* in the case of *CIT Vs. Reliance Utilities and Power Ltd.* reported in (2009) 178 TM 135 has not been disallowed. The Ld.AR emphasised that the assessee has utilized borrowed funds for the purpose of business and not for making investment as such. It is submitted that entire interest expenditure on borrowed funds were incurred and utilised in connection with business and, therefore, no disallowance is required to be made.

7.1 On the contrary, the Ld.DR submitted that there was no actual evidence on record that the investments made by the assessee is out of sufficient –funds available and that the loans and advanced were not utilized for the same.

We have perused the submission in the light of record placed before us.

7.2 From the order of the Ld.CIT(A), we note that the assessee did not furnish any details of loans borrowed along with the interest rate thereon and the loans advanced with the interest charged

thereon. The Ld.AO, therefore, disallowed excess of interest debited over the excess of interest earned.

7.3 In the interest of justice, we deem it appropriate to remand this issue back to the file of Ld.AO to verify based on the financial reports of the assessee and having regard to principle laid down by the *Hon'ble Bombay High Court* in the case of *Reliance Utility (Supra)*.

Accordingly, ground No.2 raised by assessee stands partly allowed for statistical purposes.

8. **Ground No.3** raised by assessee is in respect of disallowance computed u/s 14A of the Act.

8.1 The ld.AR submitted that the arguments advanced in respect of interest expenditure disallowed u/s 36(1)(iii) of the Act may be considered for the interest disallowed u/s 14A of the Act while computing disallowance u/s Rule 8D(2)(iii). He submitted that, own funds were available with the assessee and, therefore, it cannot be attributed that the investments were made out of borrowed funds. He thus requested for the issues to be remanded for necessary verification.

8.2 The Ld.DR reiterated that the submissions have made herein above while arguing for the ground No.2.

8.3 Regarding disallowance computed by the Ld.AO in Rule 8D(2)(iii), we note that the Ld.AO has considered past investments made by assessee that computed the 0.5% of average investment. We direct the Ld.AO to re-compute the disallowance under Rule 8D(2)(iii) by considering only those investment that have been yielded exempt income during the

year. We also hold that the disallowance shall not exceed the exempt income earned by assessee. With these riders, we remand this issue back to the Ld.AO to re-compute the disallowance under Rule 8D(2)(iii) of the Rules in accordance with law.

Accordingly this ground raised by the assessee stands partly allowed.

In the result, appeal filed by the assessee is partly allowed for statistical purposes.

Order pronounced in court on 22nd June, 2023.

Sd/-

(CHANDRA POOJARI)
Accountant Member

Sd/-

(BEENA PILLAI)
Judicial Member

Bangalore,
Dated, 22nd June, 2023
/ vms /

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| 1. Appellant | 2. Respondent |
| 3. CIT | 4. DR, ITAT, Bangalore |
| 5. Guard file | |

By order

Assistant Registrar,
ITAT, Bangalore.