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* **IN THE HIGH COURT OF DELHI AT NEW DELHI**
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\+ **ITA No. 520/2017**

PR. COMMISSIONER OF INCOME TAX-04 ..... Appellant
Through: Mr. Zoheb Hossain, Senior Standing Counsel with Mr. Rajender Dangwal, Advocate

versus

IL & FS ENERGY DEVELOPMENT COMPANY LTD .... Respondent
Through: None.

CORAM:
JUSTICE S. MURALIDHAR
JUSTICE PRATHIBA M. SINGH

O R D E R

% 16.08.2017

Dr. S. Muralidhar, J.:

1. The matter is taken up for hearing today as 14th August 2017 was declared a holiday on account of *Janmashtami*.

2. This appeal by the Revenue under Section 260 A of the Income Tax Act, 1961 ('Act') is directed against the order dated 7th November 2016 passed by the Income Tax Appellate Tribunal ('ITAT') in ITA No. 2895/Del/2015 for the Assessment Year ('AY') 2011 – 2012.

3. The question of law sought to be urged by the Revenue is whether the ITAT erred in deleting the disallowance made by the Assessing Officer ('AO') of the sum of Rs. 4,00,78,074/- from the returned income of the Assessee under Section 14A of the Act read with Rule 8D of the Income

Tax Rules, 1962 ('Rules').

4. The facts are that the Respondent-Assessee is a company engaged in provision of consultancy services. On 26th September 2011, the Assessee filed its return at a loss of Rs. 2,42,63,176/-. The Assessee was asked to explain why disallowance should not be made under Section l4A of the Act read with Rule 8D of the Rules for the purpose of normal computation of book profit for the purpose of Minimum Alternative Tax ('MAT') under Section 115JB of the Act.

5. The response of the Assessee was that it had made investment in mutual funds and that no interest bearing funds were invested to earn tax free income. It accordingly pleaded that no disallowance under Section 14A of the Act was called for.

6. However, this plea was rejected by the AO who relied on the decision of the Special Bench of the ITAT Delhi in ***Cheminvest Ltd. v. ITO [2009] 121 ITD 318 (Del) (SB)*** wherein it was held that Section 14A would apply even if during the AY in question, the investment has not actually yielded any exempt income. The AO, by the assessment order dated 20th February 2014, made an addition of Rs.15,44,43,369/- to the income of the Assessee. The AO held that the Assessee had made investments in shares to the tune of Rs.5,29,38,26,780/- for the purposes of earning dividend income not chargeable to the tax. The AO noted that, even in the tax audit report, the auditors had calculated disallowance under Section 14A read with Rule 8D in the sum of Rs. 5,89,22,873/-, which included direct expenses of Rs. 1,12,025/-.

7. The appeal filed by the Assessee was disposed of by the Commissioner of Income (Appeal) ['CIT (A)'] by an order dated 20th March 2015 observing as under:

(i) The opening balance in the investment of the appellant company, as on 31st March 2010 was Rs.44.98 lakh. The bulk of the investment was made during the year in the equity shares of ONGC Tripura Power Company Limited in the sum of Rs. 402,32,17,980/-, Himachal Sorang Power Limited in the sum of Rs.35,70,40,000/- and, SE Power Private Ltd in the sum of Rs. 28,99,60,000/-.

(ii) In terms of the decision of ITAT Delhi (Special Bench) in ***Cheminvest Ltd.*** *(supra)*, Section 14A would apply even where the investments do not give rise to exempt income pertaining to the AY in question. Further, the Central Board of Direct Taxes ('CBDT') by Circular No. 5/2014 dated 11th February 2014 clarified the above position.

(iii) On facts, it could not be held categorically that the Assessee used significant amount of its own funds only towards investments while the borrowed funds were used only towards fixed assets and loans and advances given by the Assessee. Some amount of the borrowed funds would have gone towards making investments. Even the Assessee admitted that the balance amount of loans of Rs. 175 crores could have been utilized for making investments. Consequently, the application of Rule 8D (2)(ii) of the Rules by the AO could not be said to be erroneous.

(iv) The CIT (A) reduced the disallowance to Rs. 4,00,78,074/-. The CIT (A) also reduced the interest disallowed from Rs. 29,03,54,953/- to Rs. 6,11,80,756/-.

8. The ITAT, by the impugned order dated 7th November 2016, allowed the Assessee's appeal and held as under:

(i) The Assessee had made investments in various companies amounting to Rs. 5,29,38,26,780/-. Out of said investments, an amount of Rs. 35,70,40,000/- was invested in fully convertible debentures which could yield no tax-free income.

(ii) When the Assessee did not earn any exempt income, there could not be any disallowance. Further, when the Assessee had made investments in shares of subsidiary companies and joint ventures for the purposes of business and not for earning exempted dividend income, there could not be any disallowance. This Court, in ***Cheminvest Ltd. v. Commissioner of Income Tax (2015) 378 ITR 33 (Del)***, reversed the decision of the Special Bench of the ITAT and held that Section 14A of the Income Tax Act would not apply if the Assessee had not received any exempt income in the year in question. The Gujarat High Court had, in ***CIT v. Corrtech Energy Pvt. Ltd. [2015] 372 ITR 97 (Guj)*** held likewise. The Assessee held interest free funds in the form of share capital, share application money and reserve paid surplus, which exceeded the amount invested by the Assessee. Consequently, the question of disallowance of any expenditure incurred to earn exempt income during the AY in

question did not arise.

9. Mr. Zoheb Hossain, learned Senior Standing Counsel for the Revenue, submitted that, in ***Cheminvest Ltd.*** *(supra)*, this Court had no occasion to consider the CBDT Circular No. 5/2014 dated 11th February 2014 which clarified that Section 14A would apply even when exempt income was not earned in a particular AY. According to him, the other decisions of this Court in ***CIT-IV v. Taikisha Engineering India Pvt. Ltd. [2015] 370 ITR 338 (Del)*** and ***CIT-IV v. Holcim India Pvt. Ltd. (2014) 272 CTR (Del) 282*** did not actually discuss the above Circular of the CBDT and, therefore, would be distinguishable.

10. Mr. Hossain further submitted that there was nothing in Section 14A of the Act which suggested that exempt income had to necessarily be earned in the AY in question for the applicability of the said provision. He submitted that if the interpretation placed on Section 14 A of the Act by the above CBDT Circular was not accepted, the very purpose of Section 14A would be defeated. He referred to the decisions of the ITAT in ***ACIT v. Ratan Housing Development Ltd.*** (order dated 23rd May 2008 of ITAT Lucknow) ***Relaxo Footwear Ltd. v. Addl. CIT [2012] 50 SOT 102 (Del)***.

11. At the outset, it requires to be noticed that we are concerned with the AY 2011-12 and, therefore, the question of the applicability of Rule 8D, which was inserted with effect from 24th March 2008, is not in doubt.

12. Section 14A of the Act, which was inserted with retrospective effect from 1st April 1962, provides for disallowance of the expenditure incurred in

relation to income exempted from tax. From 11th May 2001, a proviso was inserted in Section 14A to clarify that it could not be used to reopen or rectify a completed assessment. Sub-sections (2) and (3) of Section 14A were inserted with effect from 1st April, 2007 to provide for methodology for computing of disallowance under Section 14A. However, the actual methodology was provided in terms of Rule 8D only from 24th March 2008. There was a further amendment to Rule 8D with effect from 2nd June 2016 limiting the disallowance the aggregate of the amount of expenditure directly relating to income which does not form part of total income and an amount equal to one per cent of the annual average of the monthly average of the opening and closing balances of the value of investment, income from which does not form part of the total income. It is also provided that the amount shall not exceed the total expenditure claimed by the Assessee.

13. In the above background, the key question in the present case is whether the disallowance of the expenditure will be made even where the investment has not resulted in any exempt income during the AY in question but where potential exists for exempt income being earned in later AYs.

14. In the Explanatory Memorandum to the Finance Act 2001, by which Section 14A was inserted with effect from 1st April 1962, it was clarified that *"expenses incurred can be allowed only to the extent they are relatable to the earned income of taxable income"*. The object behind Section 14A was to provide that "*no deduction shall be made in respect of any expenditure incurred by the Assessee in relation to income which does not form part of the total income under the Income Tax Act"*.

15. What is taxable under Section 5 of the Act is the "total income" which is neither notional nor speculative. It has to be 'real income'. The subsequent amendment to Section 14A does not particularly clarify whether the disallowance of the expenditure would apply even where no exempt income is earned in the AY in question from investments made, not in that AY, but earlier AYs.

16. Rule 8D (1) of the Rules is helpful, to some extent, in understanding the above issue. It reads as under:

> "8D. (1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with—
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> (a) the correctness of the claim of expenditure made by the assessee;
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> or
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> (b) the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for **such previous year**,
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> he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2)."

17. The words *"in relation to income which does not form part of the total income under the Act for such previous year"* in the above Rule 8 D (1) indicates a correlation between the exempt income earned in the AY and the expenditure incurred to earn it. In other words, the expenditure as claimed by the Assessee has to be in relation to the income earned in 'such previous year'. This implies that if there is no exempt income earned in the AY in question, the question of disallowance of the expenditure incurred to earn

exempt income in terms of Section 14A read with Rule 8D would not arise.

18. The CBDT Circular upon which extensive reliance is placed by Mr. Hossain does not refer to Rule 8D (1) of the Rules at all but only refers to the word "includible" occurring in the title to Rule 8D as well as the title to Section 14A. The Circular concludes that it is not necessary that exempt income should necessarily be included in a particular year's income for the disallowance to be triggered.

19. In the considered view of the Court, this will be a truncated reading of Section 14 A and Rule 8D particularly when Rule 8D (1) uses the expression 'such previous year'. Further, it does not account for the concept of 'real income'. It does not note that under Section 5 of the Act, the question of taxation of 'notional income' does not arise. As explained in ***Commissioner of Income Tax v. Walfort Share and Stock Brokers Pvt. Ltd [2010] 326 ITR 1 (SC)***, the mandate of Section 14A of the Act is to curb the practice of claiming deduction of expenses incurred in relation to exempt income being taxable income and at the same time avail of the tax incentives by way of exemption of exempt income without making any apportionment of expenses incurred in relation to exempt income. Consequently, the Court is not persuaded that in view of the Circular of the CBDT dated 11th May 2014, the decision of this Court in ***Cheminvest Ltd.*** *(supra)* requires reconsideration.

20. In ***M/s. Redington (India) Ltd. v. The Additional Commissioner of Income Tax, Company Range – V, Chennai*** (order dated 23rd December, 2016 of the High Court of Madras in TCA No. 520 of 2016), a similar

contention of the Revenue was negated. The Court there declined to apply the CBDT Circular by explaining that Section 14A is *"clearly relatable to the earning of the actual income and not notional income or anticipated income."* It was further explained that,

> "The computation of total income in terms of Rule 8D is by way of a determination involving direct as well as indirect attribution. Thus, accepting the submission of the Revenue would result in the imposition of an artificial method of computation on notional and assumed income. We believe thus would be carrying the artifice too far."

21. The decisions in ***CIT v. M/s Lakhani Marketing Inc. 2014 SCC Online P&H 20357, CIT v. Winsome Textile Industries Limited [2009] 319 ITR 204 (P&H), CIT v. Shivam Motors (P) Ltd. (2014) 272 CTR (All) 277*** have all taken a similar view. The decision in ***Taikisha Engineering India Pvt. Ltd.*** *(supra)* does not specifically deal with this issue.

22. It was suggested by Mr. Hossain that, in the context of Section 57(iii), the Supreme Court in ***Commissioner Of Income Tax, West v. Rajendra Prasad Moody [1978] 115 ITR 519 (SC)*** explained that deduction is allowable even where income was not actually earned in the AY in question. This aspect of the matter was dealt with by this Court in ***M/s Cheminvest Ltd.*** *(supra)* where it reversed the decision of the Special Bench of the ITAT by observing as under:

> "20. Since the Special Bench has relied upon the decision of the Supreme Court in *Rajendra Prasad Moody* (*supra*), it is considered necessary to discuss the true purport of the said decision. It is noticed to begin with that the issue before the Supreme Court in the said case was whether the expenditure under Section 57 (iii) of the Act could be allowed as a deduction against dividend income assessable under the

head “income from other sources”. Under Section 57 (iii) of the Act deduction is allowed in respect of any expenditure laid out or expended wholly or exclusively for the purpose of making or earning such income. The Supreme Court explained that the expression "incurred for making or earning such income", did not mean that any income should in fact have been earned as a condition precedent for claiming the expenditure. The Court explained:

> “What s. 57(iii) requires is that the expenditure must be laid out or expended wholly and exclusively for the purpose of making or earning income. It is the purpose of the expenditure that is relevant in determining the applicability of s. 57(iii) and that purpose must be making or earning of income. s. 57(iii) does not require that this purpose must be fulfilled in order to qualify the expenditure for deduction. It does not say that the expenditure shall be deductible only if any income is made or earned. There is in fact nothing in the language of s. 57(iii) to suggest that the purpose for which the expenditure is made should fructify into any benefit by way of return in the shape of income. The plain natural construction of the language of s. 57(iii) irresistibly leads to the conclusion that to bring a case within the section, it is not necessary that any income should in fact have been earned as a result of the expenditure."

21. There is merit in the contention of Mr. Vohra that the decision of the Supreme Court in *Rajendra Prasad Moody (supra)* was rendered in the context of allowability of deduction under Section 57(iii) of the Act, where the expression used is "for the purpose of making or earning such income." Section 14A of the Act on the other hand contains the expression "in relation to income which does not form part of the total income." The decision in *Rajendra Prasad Moody (supra)* cannot be used in the reverse to contend that even if no income has been received, the expenditure incurred can be disallowed under Section 14A of the Act.”

23. The decisions of the ITAT in ***ACIT v. Ratan Housing Development Ltd.*** *(supra)* and ***Relaxo Footwear Ltd. v. Addl. CIT*** *(supra)*, to the extent that

they are inconsistent with what has been held hereinbefore do not merit acceptance. Further, the mere fact that in the audit report for the AY in question, the auditors may have suggested that there should be a disallowance cannot be determinative of the legal position. That would not preclude the Assessee from taking a stand that no disallowance under Section 14 A of the Act was called for in the AY in question because no exempt income was earned.

24. For all of the aforementioned reasons, this Court is of the view that the CBDT Circular dated 11th May 2014 cannot override the expressed provisions of Section 14A read with Rule 8D.

25. No substantial question of law arises from the impugned order of the ITAT. The appeal is accordingly dismissed.

S. MURALIDHAR, J.

PRATHIBA M. SINGH, J.

AUGUST 16, 2017
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