

Income Tax Appellate Tribunal - Mumbai

Asstt. Cit, Range 10(1) vs Citicorp Finance (India Ltd.) on 21 November, 2006

Equivalent citations: 2007 108 ITD 457 Mum, 2008 300 ITR 398 Mum, (2007) 111 TTJ Mum 82

Bench: K Thangal, Vice, D Srivastava

ORDER D.K. Srivastava, Accountant Member

1. The department has filed the present appeal on the following grounds:

1. On the facts and in the circumstances of the case and in law, the learned Commissioner (Appeals) has erred in directing to allow deduction of Rs. 1,94,96,945 on account of the provisions for accrued expenses which was correctly disallowed by the assessing officer.

2. On the facts and in the circumstances of the case and in law, the learned Commissioner (Appeals) has erred in directing to allow exemption under Section 10(33) in respect of whole dividend income of Rs. 4,85,24,362 instead of the net income rightly determined by the assessing officer at Rs. 1,17,21,951

2. Briefly stated, the facts of the case are that the assessee- company was engaged in the business of providing financial services like commercial vehicle financing, equipment finance, advances against financial assets and inter-corporate loans and deposits. During the course of the assessment proceedings, the assessing officer noticed that the assessee had earned dividend of Rs. 4,85,24,362 which was exempt from tax. Taking note of Section 14A of the Income Tax Act, he called upon the assessee to furnish the details of expenditure incurred in earning the aforesaid dividend and also to explain as to why expenditure on pro rata basis should not be apportioned to the earning of the aforesaid dividend. In reply, the assessee submitted before the assessing officer that it had not incurred any expenditure in earning the aforesaid dividend and hence the pro rata basis could not be applied to allocate the expenditure for earning the said dividend. In the absence of details, the assessing officer applied pro rata basis for allocating the total expenditure of Rs. 90,64,63,336 between exempt income (i.e., dividend) and non-exempt income in the ratio of their receipts (total receipts being 119,48,19,592 including dividend receipts of Rs. 4,85,24,362). In this manner, he quantified the expenditure at Rs. 3,68,02,411 being 4.06 per cent of total expenditure as having been incurred in relation to earning the (dividend and therefore disallowed the same while computing non-exempt income. On appeal, the learned Commissioner (Appeals), by his order dated 16-6-2003, directed the assessing officer to allow deduction on the gross amount of dividend without allocating any expenditure. department is aggrieved by the aforesaid order and is now in appeal before this Tribunal.

3. In support of appeal, the learned departmental Representative relied upon the grounds of appeal, the assessment order and the provisions of Section 14A and submitted that the impugned disallowance was in conformity with the aforesaid provisions.

4. In reply, the learned Counsel for the assessee submitted that gross dividend amounting to Rs. 4,85,24,362 was received from nine companies which was exempt from tax. According to him, dividend income was reflected in the accounts under the head "Permanent investments". It was also

submitted that all deployment of funds in permanent investments were made out of capital infusion into the assessee- company from Citicorp Overseas Investment Corporation and that all outside borrowings were made for meeting the requirements of working capital of the assessee-company and not for making the permanent investments. It was vehemently contended that since all the investments on which dividend was earned were entirely made out of own funds and, in this view of the matter, no interest expenditure incurred by the assessee was allocable to the earning of dividend income.

5. He invited our attention to the provisions of Section 14A and submitted that rule of proportionality of expenditure was not applicable for making the disallowance under Section 14A.

6. He further submitted that the issue under consideration had since been decided by this Tribunal in favour of the assessee by order dated 7-10-2005 in the department's appeal in the assessee's own case for assessment year 1998-99. In this connection, he invited our attention to para II of the said order, which reads as under:

We have heard both the parties. The Delhi Tribunal, in the case of Maruti Udyog Ltd., cited supra, has held that no disallowance could be made under Section 14A where the assessee has interest-free funds far and excess of amounts invested in shares of other companies. The assessee-company was having capital far and excess of the investment made on which the dividend income was received. Moreover, it has been held by the various courts that proportionate disallowance of expenses is not permissible. The findings of the learned Commissioner (Appeals) are upheld and the third ground is dismissed.

7. He also invited our attention to another order dated 19-1-2006 passed by this Tribunal in the department's appeal in the assessee's case for assessment year 1999-2000 in which the earlier order of the Tribunal for assessment year 1998-99 has been followed.

8. We have heard both the parties and considered their submissions including the judicial authorities cited by them. Short issue in the matter before us is whether the provisions of Section 14A empower the assessing officer to make proportionate allocation in respect of the expenditure incurred in relation to exempt income and consequentially take the same into account for computing the exempt income and, if so, whether the mechanism for computing allocation of such expenditure as provided in Sub-section (2)/(3) of Section 14A (inserted by the Finance Act, 2006) would apply to all pending matters or would apply to matters arising with effect from assessment year 2006-07.

9. Section 14A has been inserted in the Income Tax Act, Section 11 of the Finance Act, 2001, with retrospective effect from 1-4-1962, i.e., for and from assessment year 1962-63. Section 14A has been amended by Section 10 of the Finance Act, 2002 and again by Section 7 of the Finance Act, 2006. Section 14A as so amended reads now as under:

14A. Expenditure incurred in relation to income not includible in total Income.-(I) For the purposes of computing the total income under this Chapter, no deduction shall be allowed in respect of

expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.

(2) The assessing officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, if the assessing officer, having regard to the accounts of the assessee, is 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 this Act.-

(3) The provisions of Sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act:

Provided that nothing contained in this section shall empower the assessing officer either to reassess under Section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under Section 154, for any assessment year beginning on or before the 1st day of April, 2001.

(*Inserted as Section 14A (without numbering) in the Income Tax Act by the Finance Act, 2001 with retrospective effect from 1-4-1962. ** Inserted by the Finance Act, 2006 and consequently all the clauses of Section 14A were numbered. -Inserted by the Finance Act, 2002.)

10. In the matter before us, we are not concerned with the proviso to Section 14A. We are concerned with Sub-section (1) (as originally inserted (without numbering of the sub-section) by the Finance Act, 2001 with retrospective effect from 1-4-1962) and Sub-section (2)/(3) (inserted by the Finance Act, 2006 with consequential numbering of the clauses of Section 14A) of Section 14A. The scope and effect of the insertion of Section 14A, with retrospective effect from 1-4-1962, in the Income Tax Act by the Finance Act, 2001 have been explained in para 25 of Circular No. 14 of 2001 issued by the Central Board of Direct Taxes, which reads as under:

25. No deduction for expenditure incurred in respect of exempt income against taxable income.

25.1 Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect means that the tax incentive given by way of exemptions to certain categories of income, is being used to reduce also the tax payable on the non-exempt income by debiting the expenses incurred to earn the exempt income against taxable income. This is against the basic principles of taxation whereby only the net income, i.e., gross income minus the expenditure, is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

25.2 Through Finance Act, 2001, a new Section 14A has been inserted so as to clarify the intention of the Legislature since the inception of the Income Tax Act, 1961, 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.

25.3 Vide Circular No. 11/2001, dated 23-7-2001, a direction was issued by the Central Board of Direct Taxes that the assessments where the proceedings have become final before the first day of April, 2001 should not be re-opened under Section 147 of the Act to disallow expenditure relatable to the exempt income by applying the provisions of Section 14A of the Act. This circular has been issued by the Board by exercising its powers to issue beneficial circular under Section 119(2)(a) of the Income Tax Act.

25.4 This amendment takes effect retrospectively from 1-4-1962 and accordingly, applies in relation to the assessment year 1962-63 and subsequent assessment years.

11. Section 14A clearly makes a distinction between exempt income and taxable income. It treats both of them as separate classes for computation of income after allocation of expenditure relating thereto and mandates that no deduction in respect of any expenditure shall be allowed against taxable income which is incurred in relation to exempt income. The underlying object is to compute both the exempt income and taxable income correctly, which is possible only after the expenditure incurred in relation thereto is allocated to them. In other words, Section 14A bars the deduction of expenditure incurred in relation to exempt income out of taxable income, as this would have the effect of artificially inflating the exempt income and thereby deflating the taxable income.

12. The prohibition for allowing the deduction under Section 14A for and from assessment year 1962-63 is "in respect of expenditure incurred by the assessee in relation to income" which does not form part of the total income. The term "expenditure" has been defined at page 598 of Black's Law Dictionary (Seventh Edition) thus: "1. The act or process of paying out; disbursement. 2. A sum paid out." The term "expense" has been defined at the same page of the aforesaid dictionary as follows: "n. An expenditure of money, time, labour, or resources to accomplish a result; esp., a business expenditure chargeable against revenue for a specific period. - expense, vb. Cf. COST (1)." The "expense" has many forms, namely, accrued expense, administrative expense, business expense, capital expense, capitalized expense, current expense, deferred expense, educational expense, entertainment expense, extraordinary expense, fixed expense, funeral expense, general administrative expense, medical expense, moving expense, operating expense, ordinary and necessary expense, organizational expense, put-of-pocket expense, prepaid expense, travel expense. The term "expenditure" occurring in Section 14A would thus take in its sweep not only direct expenditure but also all forms of expenditure regardless of whether they are fixed, variable, direct, indirect, administrative, managerial or financial. The term "incur" has been defined at page 771 of the aforesaid dictionary as follows: "incur, vb. To suffer or bring on oneself (a liability or expense)." One of the meanings given to the word "relate" under the head "Law" at page 2534 in "The New Shorter Oxford English Dictionary" (1993 Edition) is "Have some connection with, be connected to." The phraseology used in Section 14A prohibiting the deduction in respect of expenditure incurred by the assessee in relation to exempt income is thus wide enough to cover all forms of expenses provided they have some connection with the exempt income. This is based on the principle that expenses must be allocated to that income to which they are connected to avoid distortions in the

computation of both taxable as well as exempt income. This is also achieved by the matching principle of accountancy. In *Taparia Tools Ltd. v. Jt. CIT*, the Hon'ble jurisdictional High Court has explained the matching principle as under:

The mercantile system of accounting is based on accrual. Basically, it is a double entry system of accounting. Under the mercantile system of accounting, profits arising or accruing at the date of the transaction are liable to be taxed notwithstanding the fact that they are not actually received. or deemed to be received under the Act. Under the mercantile system of accounting, therefore, book profits are liable to be taxed. The profits earned and credited in the books of account constitute the basis of computation of income. The system postulates the existence of tax in so far as monies due and payable by the parties to whom they are debited. Therefore, under the mercantile system of accounting, in order to determine the net income of an accounting year, the revenue and other incomes are matched with the cost of resources consumed (expenses). Under the mercantile system of accounting, this matching is required to be done on accrual basis. Under this matching concept, revenue and income earned during an accounting period, irrespective of actual cash in-flow, is required to be compared with expenses incurred during the same period, irrespective of actual out-flow of cash. In this case, the assessee is following the mercantile system of accounting. This matching concept is very relevant to compute taxable income....

13. It is difficult to accept the hypothesis that one can earn substantial dividend income without incurring any expenses whatsoever including management or administrative expenses. By same logic, it is equally difficult to accept that the only expenses involved in earning the dividend income are those incurred on collection of dividend or on encashing a few dividend warrants. A company cannot earn dividend without its existence and management. Investment decisions are very complex in nature. They require substantial market research, day-to-day analysis of market trends and decisions with regard to acquisition, retention and sale of shares at the most appropriate time. They require huge investment in shares and consequential blocking of funds. It is well known that capital has cost and that element of cost is represented by interest. Besides, investment decisions are generally taken in the meetings of the Board of Directors for which administrative expenses are incurred. It is therefore not correct to say that dividend income can be earned by incurring no or nominal expenditure. This aspect of the matter has also received careful attention of Chennai Bench of this Tribunal in *Southern Petro Chemical Industries v. Dy. CIT* (2005) 3 SOT 157 (Chennai-Trib). After comprehensive consideration of all the relevant aspects of the case including the provisions of law, the Chennai Bench has held that investment decisions are very strategic decisions in which top management is involved and therefore proportionate management expenses are required to be deducted while computing the exempt income from dividend. In *Harish Krishnakant Bhatt v. Income Tax Officer* (2004) 91 ITD 311 (Ahd.), the Ahmedabad Bench of this Tribunal has held that, the dividend income being exempt under Section 10(33), the interest on capital borrowed for acquisition of relevant shares yielding such dividend cannot be allowed deduction by operation of Section 14A. In *Dy. CIT v. SG Investments & Industries Ltd.* (2004) 89 ITD 44 (Cal.), the Calcutta Bench of this Tribunal has laid down two propositions: one, in view of Section 14A inserted in the Income Tax Act with retrospective effect from 1-4-1962, pro rata expenses on account of interest relatable to investment in shares for earning exempt income from dividend are to be disallowed against taxable income and only the net dividend income is to be allowed exemption after deducting

the expenses; and two, the expression "expenditure incurred by the assessee in relation to income which does not form part of the total income" in Section 14A has to be given a wider meaning and would include both direct and indirect relationship between expenditure and exempt income. Following the decision of the Hon'ble Supreme Court in CIT v. United General Trust Ltd. , the Calcutta Bench of the Tribunal has also held that the interest paid by the assessee being attributable to the money borrowed for the purpose of making the investment which yielded the dividend and other expenses incurred in connection with or for making or earning the dividend income can be regarded as expenditure incurred in relation to dividend income. In Everplus Securities & Finance Ltd. v. Dy. CIT (2006) 101 ITD 151 (Del), the Delhi Bench of this Tribunal has held that merely because the assessee did not earn the dividend out of investment in certain shares does not imply that the provisions of Section 14A would not apply to that extent. In Asstt. CIT v. Premier Consolidated Capital Trust (I). Ltd. (2004) 83 TTJ (Mum.) 843, the Mumbai Bench of this Tribunal has held that the assessing officer is justified in attributing a part of the financial and administrative expenses as expenditure incurred in relation to exempt income and disallowing the same in view of the provisions of Section 14A.

14. Keeping in view the provisions of Section 14A as also the aforesaid decisions of the co-ordinate Benches of this Tribunal, we hold that all expenses connected with the exempt income have to be disallowed under Section 14A regardless of whether they are direct or indirect, fixed or variable and managerial or financial in accordance with law. In this connection, the provisions of Sub-section (2)/(3) of Section 14A inserted by the Finance Act, 2006 deserve to be noted.

15. The procedure for computation of disallowance has now been provided in Sub-sections (2) and (3) of Section 14A of the Income Tax Act. It is no longer open to the assessing officer to apply his discretion in computing the disallowance or make ad hoc disallowance under Section 14A. Substantive provisions are contained in Sub-section (1) of Section 14A prohibiting deduction in respect of expenditure incurred in relation to exempt income while procedural provisions regarding computation of the aforesaid disallowance are contained in Sub-sections (2) and (3) thereof. Sub-sections (2) and (3) seek to achieve the underlying object of Section 14A(1) that any expenditure incurred in relation to exempt income should not be allowed deduction. It is fairly well-settled by a catena of decisions that procedural provisions apply to all pending matters and that the rule against retrospectivity does not hit them.

16. In W.H. Cockerline and Co. v. IRC (1930) 16 TC I (CA) at 19, Lord Hanworth quoted with approval the following passage from the judgment of Sargant L. J.:

The liability is imposed by the charging section, namely, Section 38, the words of which are clear. The subsequent provisions as to assessment and so on are machinery only. They enable the liability to be quantified, and when quantified to be enforced against the subject, but the liability is definitely and finally created by the charging section and all the materials for ascertaining it are available immediately." In Halsbury's Law of England (Fourth edition, Vol. 23, paragraph 29), referring to the machinery provisions, it is stated: "It is important to distinguish between charging provisions, which impose the charge to tax, and machinery provisions, which provide the machinery for the quantification of the charge and the levying and collection of the tax in respect of the charge so

imposed. Machinery provisions do not impose a charge or extend or restrict a charge elsewhere clearly imposed." In *Kesoram Industries & Cotton Mills Ltd. v. CWT* Hon'ble Mr. Justice Shah observed: "Section 7(2) merely provides machinery in certain special cases for valuation of assets, and it is from the aggregate valuation of assets that the net wealth chargeable to tax may be ascertained.... This is an artificial rule adopted with a view to avoid investigation of a mass of evidence which it would be difficult to secure or, if secured, may require prolonged investigation." Though the aforesaid observation was part of the minority opinion, there is, however, nothing said to the contra in the majority view. In *Associated Cement Co. Ltd. v. CTO* (1981) 48 STC 466 (SC), the Hon'ble Supreme Court has held: "It is settled law that a distinction has to be made by courts while interpreting the provisions of a taxing statute between charging provisions which impose the charge to tax and machinery provisions which provide the machinery for the quantification of the tax and the levying and collection of the tax so imposed. While charging provisions are construed strictly, machinery sections are not generally subject to a rigorous construction. The courts are expected to construe the machinery sections in such a manner that a charge to tax is not defeated." Bennions Statutory Interpretation (First edition, page 446, paragraph 191) lays down as follows: "Because a change made by the legislator in procedural provisions is expected to be for the general benefit of litigants and others, it is presumed that it applies to pending as well as future proceedings." At page 447, it is stated: "Procedure and practice is the mere machinery of law enforcement. As Ormrod L.J. said : 'The object of all procedural rules is to enable justice to be done between the parties consistently with the public interest'." In *Jose Da Costa v. Bascora Sadashiva Sinai Narcornim*, the Hon'ble Supreme Court has held at page 1849 of AIR 1975 SC. "Before ascertaining the effect of the enactments aforesaid passed by the Central Legislature on pending suits or appeals, it would be appropriate to bear in mind two well-established principles. The first is that 'while provisions of a statute dealing merely with matters of procedure may properly, unless that construction be textually inadmissible, have retrospective effect attributed to them, provisions which touch a right in existence at the passing of the statute are not to be applied retrospectively in the absence of express enactment or necessary intendment' (See *Delhi Cloth and General Mills Co. Ltd. v. ITC* AIR 1927 PC 242). The second is that a right of appeal being a substantive right the institution of a suit carries with it the implication that all successive appeals available under the law then in force would be preserved to the parties to the suit throughout the rest of the career of the suit. There are two exceptions to the application of this rule, viz., (i) when by competent enactment such right of appeal is taken away expressly or impliedly with retrospective effect; and (ii) when the court to which appeal lay at the commencement of the suit stands abolished (See *Garikapatti Veeraya v. N. Subbiah Choudhury*, and *Colonial Sugar Refining Co. Ltd v. Irving* (1905) AC 369 (PC))" Halsbury's Laws of England (Fourth edition, Vol. 44, paragraph 925) states : "The presumption against retrospection does not apply to legislation concerned merely with matters of procedure or of evidence; on the contrary, provisions of that nature are to be construed as retrospective unless there is a clear indication that such was not the intention of Parliament." All the aforesaid observations have been cited, with approval, by the Hon'ble Supreme Court in *CWT v. Sharvan KumarSwarup & Sons*.

17. In view of the aforesaid, we hold that the provisions for quantification of disallowance as contained in Sub-sections (2) and (3) of Section 14A are procedural and therefore apply to all pending matters. It is no longer open to the assessing officer to make disallowance according to his

own discretion or on ad hoc basis. He is statutorily required to compute the disallowance in the manner provided by Sub-sections (2) and (3) of Section 14A. We therefore set aside the orders passed by the Commissioner (Appeals) and the assessing officer in this behalf and restore the matter to the assessing officer for a fresh examination and decision in the light of the provisions of Section 14A including Sub-sections (2) and (3) thereof, in accordance with law.

18. We are aware that the Rule' of Consistency requires us to follow the orders of the co-ordinate Benches of this Tribunal till there is a change in either the factual situation or the legal position. In the case before us, Sub-sections (2) and (3) of Section 14A were not available on the statute book when the orders were passed by this Tribunal in the assessee's own case for earlier two years. We have already held above that the aforesaid provisions have retroactive operation and therefore would apply to all pending matters. They cannot therefore be ignored. Besides, other relevant decisions rendered by this Tribunal in the cases cited supra were also not brought to the notice of this Tribunal at the time when department's appeal for earlier two years in the assessee's own case were decided.

19. In view of the foregoing, the appeal filed by the department is treated as allowed for statistical purposes.