The South Indian Bank Ltd. vs The Commissioner Of Income Tax on 9 September, 2021

Equivalent citations: AIR 2021 SUPREME COURT 4266, AIRONLINE 2021 SC 706

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Bench: A.M. Khanwilkar, Hrishikesh Roy, C.T. Ravikumar

[REPORTABLE]

IN THE SUPREME COURT OF INDIA
CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NO. 9606 OF 2011

SOUTH INDIAN BANK LTD. APPELLANT(S)

VERSUS

COMMISSIONER OF INCOME TAX RESPONDENT(S)

WITH

CIVIL APPEAL NO. OF 2021
[Arising out of SLP(C) No. 32761 OF 2018]

CIVIL APPEAL NO. 9609 OF 2011

CIVIL APPEAL NO. 9610 OF 2011

CIVIL APPEAL NO. 9611 OF 2011

CIVIL APPEAL NO. 9615 OF 2011

CIVIL APPEAL NO. 9608 OF 2011

CIVIL APPEAL NO. 9612 OF 2011

CIVIL APPEAL NO. 9614 OF 2011

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Reason:

CIVIL APPEAL NO. 9613 OF 2011

CIVIL APPEAL NO. 9607 OF 2011

CIVIL APPEAL NO. 3367 OF 2012

CIVIL APPEAL NO. 2963 OF 2012

J U D G M E N T

Hrishikesh Roy, J.

1. Leave granted in SLP(C) No. 32761/2018 for analogous consideration with the related appeals.

2. The question of law to be answered in the present batch of appeals is on interpretation of Section 14A of the Income Tax Act (for short "the Act") and the same reads as follows:

> "Whether proportionate disallowance of interest paid by the banks is called for under Section 14A of Income Tax Act for investments made in tax free bonds/ securities which yield tax free dividend and interest to assessee Banks when assessee had sufficient interest free own funds which were more than the investments made"

3. While common arguments have been advanced by the learned counsel for the parties, to place the legal issues in the appropriate perspective, the relevant facts are adverted from the Civil Appeal No. 9606 of 2011 (South Indian Bank Ltd. Vs. CIT, Trichur), for the purpose of this judgment.

4. The assessees are scheduled banks and in course of their banking business, they also engage in the business of investments in bonds, securities and shares which earn the assessees, interests from such securities and bonds as also dividend income on investments in shares of companies and from units of UTI etc. which are tax free.

5. Chapter IV of the Act provides for the Heads of Income for computation of Total Income. In Section 14, the various incomes are classified under Salaries, Income from house property, Profit & Gains of business or profession, Capital Gains & Income from other sources. The Section 14A relates to expenditure incurred in relation to income which are not includable in Total Income and which are exempted from tax. No taxes are therefore levied on such exempted income. The Section 14A had been incorporated in the Income Tax Act to ensure that expenditure incurred in generating such tax exempted income is not allowed as a deduction while calculating total income for the concerned assessee.

6. Section 14A was introduced to the Income Tax Act by the Finance Act, 2001 with retrospective effect from 01.04.1962. The new section was inserted in aftermath of judgment of this Court in the

case of Rajasthan State Warehousing Corporation Vs. CIT1. The said Section provided for disallowance of expenditure incurred by the assessee in relation to income, which does not form part of their total income. As such if the assessee incurs any expenditure for earning tax free income such as interest paid for funds borrowed, for investment in any business which earns tax free income, the assessee is disentitled to deduction of such interest or other expenditure. Although the provision was introduced retrospectively from 01.04.1962, the retrospective effect was neutralized by a proviso later introduced by the Finance Act, 2002 with effect from 11.05.2001 whereunder, re-assessment, rectification of assessment was prohibited for any assessment year, up-to the assessment year 2000-2001, when the proviso was introduced, without making any disallowance under Section 14A. The earlier assessments were therefore permitted to attain finality. As such the disallowance under Section 14A was intended to cover pending assessments and for the assessment years commencing from 2001-2002. It may be noted that in the present batch of appeals, we are concerned with 1 [(2000) 242 ITR 450 SC] / (2000) 3 SCC 126.

disallowances made under Section 14A for assessment years commencing from 2001-2002 onwards or for pending assessments.

7. At outset it is clarified that none of the assessee banks amongst the appellants, maintained separate accounts for the investments made in bonds, securities and shares wherefrom the tax-free income is earned so that disallowances could be limited to the actual expenditure incurred by the assessee. In other words, the expenditure incurred towards interest paid on funds borrowed such as deposits utilized for investments in securities, bonds and shares which yielded the tax-free income, cannot conveniently be related to a separate account, maintained for the purpose. The situation is same so far as overheads and other administrative expenditure of the assessee.

8. In absence of separate accounts for investment which earned tax free income, the Assessing Officer made proportionate disallowance of interest attributable to the funds invested to earn tax free income. The assessees in these appeals had earned substantial tax-free income by way of interest from tax free bonds and dividend income which also is tax free. It is manifest that substantial expenditure is incurred for earning tax free income. Since actual expenditure figures are not available for making disallowance under Section 14A, the Assessing Officer worked out proportionate disallowance by referring to the average cost of deposit for the relevant year. The CIT (A) had concurred with the view taken by the Assessing Officer.

9. The ITAT in Assessee's appeal against CIT(A) considered the absence of separate identifiable funds utilized by assessee for making investments in tax free bonds and shares but found that assessee bank is having indivisible business and considering their nature of business, the investments made in tax free bonds and in shares would therefore be in nature of stock in trade. The ITAT then noticed that assessee bank is having surplus funds and reserves from which investments can be made. Accordingly, it accepted the assessee's case that investments were not made out of interest or cost bearing funds alone. In consequence, it was held by the ITAT that disallowance under Section 14A is not warranted, in absence of clear identity of funds.

10. The decision of the ITAT was reversed by the High Court by acceptance of the contentions advanced by the Revenue in their appeal and accordingly the Assessee Bank is before us to challenge the High Court's decision which was against the assessee.

11. Since, the scope of Section 14A of the Act will require interpretation, the Section with sub-clauses (2) and (3) along with the proviso is extracted hereinbelow: -

> "14A. Expenditure incurred in relation to income not includible in total income - (1) 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.
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> (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."

12. The sub-Section (2) and (3) were introduced to the main section by the Finance Act, 2006 with effect from 01.04.2007.

13. The question therefore to be answered is whether Section 14A, enables the Department to make disallowance on expenditure incurred for earning tax free income in cases where assessees like the present appellant, do not maintain separate accounts for the investments and other expenditures incurred for earning the tax-free income.

14. We have heard Mr. S. Ganesh, Mr. S.K. Bagaria, Mr. Jehangir Mistri and Mr. Joseph Markose, learned Senior Counsel appearing for the appellants. Also heard Mr. Vikramjit Banerjee, learned Additional Solicitor General and Mr. Arijit Prasad, learned Senior Counsel on behalf of the respondent/Revenue.

15. The appellants argue that the investments made in bonds and shares should be considered to have been made out of interest free funds which were substantially more than the investment made

and therefore the interest paid by the assessee on its deposits and other borrowings, should not be considered to be expenditure incurred in relation to tax free income on bonds and shares and as a corollary, there should be no disallowance under Section 14A of the Act. On the other hand, the counsel for the revenue refers to the reasoning of the CIT(A) and of the High Court to project their case.

16. As can be seen, the contention on behalf of the assessee was rejected by the CIT(A) as also by the High Court primarily on the ground that the assessee had not kept their interest free funds in separate account and as such had purchased the bonds/shares from mixed account. This is how a proportionate amount of the interest paid on the borrowings/deposits, was considered to have been incurred to earn the tax-free income on bonds/shares and such proportionate amount was disallowed applying Section 14A of the Act.

17. In a situation where the assessee has mixed fund (made up partly of interest free funds and partly of interest- bearing funds) and payment is made out of that mixed fund, the investment must be considered to have been made out of the interest free fund. To put it another way, in respect of payment made out of mixed fund, it is the assessee who has such right of appropriation and also the right to assert from what part of the fund a particular investment is made and it may not be permissible for the Revenue to make an estimation of a proportionate figure. For accepting such a proposition, it would be helpful to refer to the decision of the Bombay High Court in Pr. CIT v. Bombay Dyeing and Mfg. Co. Ltd2 where the answer was in favour of the assessee on the question, whether the Tribunal was justified in deleting the disallowance under Section 80M of the Act on the presumption that when the funds available to the assessee were both interest free and loans, the investments made would be out of the interest free funds available with the assessee, provided the interest free funds were sufficient to meet the investments. The resultant SLP of the Revenue challenging the Bombay High Court judgment was dismissed both on merit and on delay by this Court. The merit of the above proposition of law of the Bombay High Court would now be appreciated in the following discussion.

18. In the above context, it would be apposite to refer to a similar decision in Commissioner of Income Tax (Large Tax Payer Unit) Vs. Reliance Industries Ltd3 where a Division Bench of this Court expressly held that where there is finding of fact that interest free funds available to assessee were sufficient to meet its investment it will be presumed that investments were made from such interest free funds.

19. In HDFC Bank Ltd. Vs. Deputy Commissioner of Income Tax4, the assessee was a Scheduled Bank and the issue therein also pertained to disallowance under Section 14A. In this case, the Bombay High Court even while remanding the case back to Tribunal for adjudicating afresh observed (relying on its own previous judgment in same assessee's case for a different Assessment Year) that, if assessee possesses sufficient interest free funds as against investment in tax free securities then, there is a presumption that investment which has been made in tax free securities, has come out of interest free funds available with assessee. In such situation Section 14A of the Act would not be applicable. Similar views have been expressed 3 (2019) 410 ITR 466 SC/ (2019) 20 SCC 478.

4 (2016) 383 ITR 529 (Bom) / 2016 SCC Online Bom 1109 by other High Courts in CIT Vs. Suzlon Energy Ltd.5, CIT Vs. Microlabs Ltd.6 and CIT Vs. Max India Ltd.7 Mr. S Ganesh the learned Senior Counsel while citing these cases from the High Courts have further pointed out that those judgments have attained finality. On reading of these judgments, we are of the considered opinion that the High Courts have correctly interpreted the scope of Section 14A of the Act in their decisions favouring the assessees.

20. Applying the same logic, the disallowance would be legally impermissible for the investment made by the assessees in bonds/shares using interest free funds, under Section 14A of the Act. In other words, if investments in securities is made out of common funds and the assessee has available, non-interest-bearing funds larger than the investments made in tax- free securities then in such cases, disallowance under Section 14A cannot be made.

21. On behalf of Revenue Mr. Arijit Prasad, the learned Senior Advocate refers to SA Builders v. CIT8 where this Court ruled on issue of disallowance in relation to funds lent to sister concern out of mixed funds. The issue in SA 5 (2013) 354 ITR 630 (Guj)/ 2013 SCC Online Guj 8613 6 (2016) 383 ITR 490 (Karn)/ 2016 SCC Online Kar 8490 7 (2016) 388 ITR 81 (P & H) / 2016 SCC Online P&H 6788 8 [(2007) 1 SCC 781] Builders is pending consideration before the larger bench of this Court in SLP (C) No. 14729 of 2012 titled as Addl. CIT v. Tulip Star Hotels Ltd. The counsel therefore, argues that there is no finality on the issue of disallowance, when mixed funds are used. On this aspect, since the issue is pending before a larger Bench, comments from this Bench may not be appropriate. However, at the same time it is necessary to distinguish the facts of present appeals from those in SA Builders/Tulip Star Hotels Ltd. In that case, loans were extended to sister concern while here the Assessee- Banks have invested in bonds/securities. The factual scenario is different and distinguishable and therefore the issue pending before the larger Bench should have no bearing at this stage for the present matters.

22. The High Court herein endorsed the proportionate disallowance made by the Assessing Officer under Section 14A of the Income Tax Act to the extent of investments made in tax-free bonds/securities primarily because, separate account was not maintained by assessee. On this aspect we wanted to know about the law which obligates the assessee to maintain separate accounts. However, the learned ASG could not provide a satisfactory answer and instead relied upon Honda Siel Power Products Ltd. v. DCIT9 to argue that it is the responsibility of the assessee to fully disclose all material facts. The cited judgment, as can be seen, mainly dealt with re-opening of assessment in view of escapement of income. The contention of department for re-opening was that the assessee had earned tax-free dividend and had claimed various administrative expenses for earning such dividend income and those (though not allowable) was allowed as expenditure and therefore the income had escaped assessment. On this, suffice would be to observe that the action in Honda Siel (supra) related to re-opening of assessment where full disclosure was not made. An assessee definitely has the obligation to provide full material disclosures at the time of filing of Income Tax Return but there is no corresponding legal obligation upon the assessee to maintain separate accounts for different types of funds held by it. In absence of any statutory provision which compels the assessee to maintain separate accounts for different types of funds, the judgment cited by the learned ASG will have no application to support the Revenue's contention against the

assessee. 9 [(2012) 12 SCC 762]

23. It would now be appropriate to advert in some detail to Maxopp Investment Ltd. v. CIT10. This case interestingly is relied by both sides' counsel. Writing for the Bench, Justice Dr. A.K. Sikri noted the objective for incorporation of Section 14A in the Act in the following words: -

> "3..... The purpose behind Section 14-A of the Act, by not permitting deduction of the expenditure incurred in relation to income, which does not form part of total income, is to ensure that the assessee does not get double benefit. Once a particular income itself is not to be included in the total income and is exempted from tax, there is no reasonable basis for giving benefit of deduction of the expenditure incurred in earning such an income....." The following was written explaining the scope of Section 14-A(1):
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> "41. In the first instance, it needs to be recognised that as per Section 14-A(1) of the Act, deduction of that expenditure is not to be allowed which has been incurred by the assessee "in relation to income which does not form part of the total income under this Act". Axiomatically, it is that expenditure alone which has been incurred in relation to the income which is includible in total income that has to be disallowed. If an expenditure incurred has no causal connection with the exempted income, then such an expenditure would obviously be treated as not related to the income that is exempted from tax, and such expenditure would be allowed as business expenditure. To put it differently, such 10 (2018) 15 SCC 523 expenditure would then be considered as incurred in respect of other income which is to be treated as part of the total income." Adverting to the law as it stood earlier, this Court rejected the theory of dominant purpose suggested by the Punjab & Haryana High Court and accepted the principle of apportionment of expenditure only when the business was divisible, as was propounded by the Delhi High Court.

Finally adjudicating the issue of expenditure on shares held as stock-in-trade, the following key observations were made by Justice Sikri:

> " 50. It is to be kept in mind that in those cases where shares are held as "stock-in-trade", it becomes a business activity of the assessee to deal in those shares as a business proposition. Whether dividend is earned or not becomes immaterial. In fact, it would be a quirk of fate that when the investee company declared dividend, those shares are held by the assessee, though the assessee has to ultimately trade those shares by selling them to earn profits. The situation here is, therefore, different from the case like Maxopp Investment Ltd. [Maxopp Investment Ltd. v. CIT, 2011 SCC OnLine Del 4855 : (2012) 347 ITR 272] where the assessee would continue to hold those shares as it wants to retain control over the investee company. In that case, whenever dividend is declared by the investee company that would necessarily be earned by the assessee and the assessee alone. Therefore, even at the time of investing into those shares, the assessee knows that it may generate dividend income

> as well and as and when such dividend income is generated that would be earned by the assessee.

In contrast, where the shares are held as stock- in-trade, this may not be necessarily a situation. The main purpose is to liquidate those shares whenever the share price goes up in order to earn profits……." The learned Judge then considered the implication of Rule 8D of the Rules in the context of Section 14-A(2) of the Act and clarified that before applying the theory of apportionment, the Assessing Officer must record satisfaction on Suo Moto disallowance only in those cases where, the apportionment was done by the assessee. The following is relevant for the purpose of this judgment:

> 51. ……..It will be in those cases where the assessee in his return has himself apportioned but the AO was not accepting the said apportionment. In that eventuality, it will have to record its satisfaction to this effect……."

24. Another important judgment dealing with Section 14A disallowance which merits consideration is Godrej and Boyce Manufacturing Company Ltd. V. DCIT11. Here the assessee had access to adequate interest free funds to make investments and the issue pertained to disallowance of expenditure incurred to earn dividend income, which was not forming part 11 [(2017) 7 SCC 421.

of total income of the Assessee. Justice Ranjan Gogoi writing the opinion on behalf of the Division Bench observed that for disallowance of expenditure incurred in earning an income, it is a condition precedent that such income should not be includible in total income of assessee. This Court accordingly concluded that for attracting provisions of Section 14A, the proof of fact regarding such expenditure being incurred for earning exempt income is necessary. The relevant portion of Justice Gogoi's judgment reads as follow:

> "36. …… what cannot be denied is that the requirement for attracting the provisions of Section 14-A (1) of the Act is proof of the fact that the expenditure sought to be disallowed/deducted had actually been incurred in earning the dividend income……."

> 25. Proceeding now to another aspect, it is seen that the Central Board of Direct Taxes (CBDT) had issued the Circular no. 18 of 2015 dated 02.11.2015, which had analyzed and then explained that all shares and securities held by a bank which are not bought to maintain Statutory Liquidity Ratio (SLR) are its stock-in-trade and not investments and income arising out of those is attributable, to business of banking. This Circular came to be issued in the aftermath of CIT Vs. Nawanshahar Central Cooperative Bank Ltd.12 wherein this Court had held that investments made by a banking concern is part of their banking business. Hence the income earned through such investments would fall under the head Profits & Gains of business. The Punjab and Haryana High Court, in the case of Pr. CIT, vs. State Bank of Patiala13 while adverting to the CBDT Circular, concluded correctly that shares and securities held by a bank are stock in trade, and all income received on such shares and securities

> must be considered to be business income. That is why Section 14A would not be attracted to such income.
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> 26. Reverting back to the situation here, the Revenue does not contend that the Assessee Banks had held the securities for maintaining the Statutory Liquidity Ratio (SLR), as mentioned in the circular. In view of this position, when there is no finding that the investments of the Assessee are of the related category, tax implication would not arise against the appellants, from the said circular.
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> 27. The aforesaid discussion and the cited judgments advise this Court to conclude that the proportionate disallowance of interest is not warranted, under Section 14A of Income

12 [(2007) 15 SCC 611] / [(2007) 160 TAXMAN 48 (SC)] 13 2017 (393) ITR 476 (P&H) Tax Act for investments made in tax free bonds/ securities which yield tax free dividend and interest to Assessee Banks in those situations where, interest free own funds available with the Assessee, exceeded their investments. With this conclusion, we unhesitatingly agree with the view taken by the learned ITAT favouring the assessees.

28. The above conclusion is reached because nexus has not been established between expenditure disallowed and earning of exempt income. The respondents as earlier noted, have failed to substantiate their argument that assessee was required to maintain separate accounts. Their reliance on Honda Siel (Supra) to project such an obligation on the assessee, is already negated. The learned counsel for the revenue has failed to refer to any statutory provision which obligate the assessee to maintain separate accounts which might justify proportionate disallowance.

29. In the above context, the following saying of Adam Smith in his seminal work – The Wealth of Nations may aptly be quoted:

> "The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person." Echoing what was said by the 18th century economist, it needs to be observed here that in taxation regime, there is no room for presumption and nothing can be taken to be implied. The tax an individual or a corporate is required to pay, is a matter of planning for a tax payer and the Government should endeavour to keep it convenient and simple to achieve maximization of compliance. Just as the Government does not wish for avoidance of tax equally it is the responsibility of the regime to design a tax system for which a subject can budget and plan. If proper balance is achieved between these, unnecessary litigation can be avoided without compromising on generation of revenue.

30. In view of the forgoing discussion, the issue framed in these appeals is answered against the Revenue and in favour of the assessee. The appeals by the Assessees are accordingly allowed with no

order on costs.

... ... J . [S A N J A Y K I S H A N K A U L]
.....J. [HRISHIKESH ROY] NEW DELHI SEPTEMBER 09, 2021