

AO couldn't apply Rule 8D just because interest free & interest bearing funds were used for making investment

Summary – The High Court of Gujarat in a recent case of Shreno Ltd., (the Assessee) held that Mere fact that assessee availed of mixed funds i.e. interest free as well as interest bearing funds, and utilised them for making investments in securities earning tax free income, applicability of section 14A, read with rule 8D would not be automatic

Facts

- The assessee was engaged in the business of manufacturing glass ware items, machinery and equipments for chemical glass and other industries and also in real estate development. During the assessment proceedings the Assessing Officer noticed that the assessee had earned dividend income which was claimed as exempt income under section 10(34). The assessee had on its own added back an amount of Rs. 1 lac as disallowance under section 14A of the Act towards administrative expenses incurred for earning such exempt income.
- The Assessing Officer noted that the business funds and investment funds of the assessee were mixed up and it could not be assumed that the funds deployed for earning tax free income were entirely out of interest free funds and resultantly the entire interest cost was to be loaded on to activities leading to taxable income. He thus computed disallowance by invoking provisions of section 14A, read with Rule 8D of 1962 Rules.
- The Tribunal opined that Assessing Officer had to record a specific satisfaction before resorting to disallowance under section 14A read with rule 8D to the effect that disallowance offered by the assessee was inadequate to cover the expenses incurred in earning tax exempt income. Resorting to the method prescribed under rule 8D was not automatic. Accordingly, the Tribunal deleted disallowance made by the Assessing Officer.

Held

- Section 14A relates to expenditure incurred in relation to income not includable in total income. Sub-section (1) of section 14A provides that for the purposes of computing total income under Chapter-IV 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 the Act. As per sub-section (2) of section 14A the Assessing Officer would determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with the method as may be prescribed, if having regard to the accounts of the assessee he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. The method for such purpose has been prescribed under rule 8D of the rules. Sub-rule (1) of rule 8D substantially reiterates what sub-section (2) of section 14A provides. Essentially under sub-rule (1), the Assessing Officer would be authorized to determine the expenditure to be disallowed in relation to earning tax

free income in terms of sub-rule (2) where having regard to the accounts of the assessee of the previous year he is not satisfied with the correctness of the claim of expenditure made by the assessee or the claim made by the assessee is that no expenditure has been incurred in relation to income which does not form part of total income.

- The exposition of law made by the Supreme Court in case of *S.A. Builders Ltd. v. CIT (Appeals)* [2007] 158 Taxman 74/288 ITR 1 and observation made therein have been applied by this court on various occasions, particularly in connection with the disallowance to be made under section 14A of the Act. It has been held that if the assessee can demonstrate availability of surplus interest free funds for making investment generating tax free income, disallowance under section 14A of the Act would not be justified.
- In case of this very assessee such an issue came up for consideration for the assessment year 2008-09. In such case the Tribunal had held that section 14A read with rule 8D could be applied only after the Assessing Officer is not satisfied with the claim of the assessee regarding the expenditure. The revenue had approached the High Court against the judgment of the Tribunal. The Court dismissed the appeal by judgment.
- The primary question which the Supreme Court considered in case of *Maxopp Investment Ltd. v. CIT* [2018] 91 taxmann.com 154/254 Taxman 325/402 ITR 640 was whether disallowance of expenditure under section 14A of the Act would be applicable in a case where shares or stocks of a company were purchased for the purpose of gaining control over the said company and incidentally tax free dividend income was generated. The assessee had contended that the dominant intention for purchasing the shares was not for earning the dividend but to gain control over the business in the company in which the shares were purchased. The Supreme Court held that the purpose for which the shares were purchased was inconsequential. As long as such investment generated tax free income, disallowance of expenditure for making such investment would be justified. This issue does not arise in the present case. However, it is true that while disposing of bunch of appeals by the said judgment the Supreme Court also considered the correctness of the view of the Punjab & Haryana High Court in case of *Avon Cycles Ltd. v. CIT* [2015] 53 taxmann.com 297/28 Taxman 368 (Mag.). It was the case in which the Assessing Officer had invoked section 14A read with Rule 8D and apportion the expenditure between investments made for earning tax free income and the rest.
- The Commissioner (Appeals) had deleted the entire disallowance upon which in the appeal filed by the revenue the Tribunal restored portion of the disallowance observing that the funds utilised by the assessee being mixed funds, the disallowance is confirmed in view of the provisions under rule 8D(2) of the Rules. This decision of the Tribunal was challenged before the High Court. The Court held that the funds utilised by the assessee were mixed funds and the interest paid by the assessee is also an interest on the investments made, was the finding of fact and, therefore, no substantial question of law arises. This judgment was carried in appeal by the assessee. The Supreme Court dismissed the appeal confirming the decision of the High Court.

Tenet Tax Daily February 22, 2019

- There is nothing to show that this portion of the judgment of the Supreme Court in case of *Maxopp Investment Ltd.(supra)*, can be seen as fundamentally changing the understanding and interpretation of section 14A and rule 8D of the rules adopted by this Court and various Courts, noted above. This judgment does not lay down a proposition that the requirement of sub-rule (1) of rule 8D of the satisfaction to be arrived by the Assessing Officer before applying the formula given in sub-rule (2) of rule 8D is done away with. In other words, the judgment in case of *Maxopp Investment Ltd.(supra)*, does not lay down a proposition that the moment it is demonstrated that the assessee had availed of mixed funds *i.e.* interest free as well as interest bearing funds and utilised them for making investments into securities earning tax free income and the rest applicability of the section 14A read with Rule 8D would be automatic.
- In view of the discussion above, the situation would not change on account of the said judgment of the Supreme Court.