



IN THE HIGH COURT OF KARNATAKA AT BENGALURU

DATED THIS THE 20TH DAY OF NOVEMBER, 2015

PRESENT

THE HON'BLE MR. JUSTICE VINEET SARAN

AND

THE HON'BLE MR. JUSTICE MOHAN M. SHANTANAGOUDAR

ITA NO.423/2014

BETWEEN:

1. THE COMMISSIONER OF INCOME TAX
C R BUILDING, QUEENS ROAD
BANGALORE.
2. THE DEPUTY COMMISSIONER
OF INCOME TAX, CIRCLE-11(5)
RASHTROTHANA BHAVAN
NRUPATHUNGA ROAD, BANGALORE.

... APPELLANTS

(BY SRI. K.V.ARAVIND, ADV.)

AND:

M/S. KARNATAKA STATE
INDUSTRIAL & INFRASTRUCTURE
DEVELOPMENT CORPN. LTD.,
KHANIJA BHAVAN,
NO.49, 5TH FLOOR, EAST WING,
RACE COURSE ROAD, BANGALORE-560 017.

...RESPONDENT

(BY SRI A.SHANKAR, ADV.,)

THIS ITA IS FILED UNDER SEC.260-A OF INCOME TAX ACT, 1961, ARISING OUT OF ORDER DATED 2.5.14 PASSED IN ITA NO.1515/BANG/2012, FOR THE ASSESSMENT YEAR 2009-10 PRAYING TO I. FORMULATE THE SUBSTANTIAL QUESTIONS OF LAW II. ALLOW THE APPEAL AND SET ASIDE THE ORDERS PASSED BY THE ITAT, BANGALORE, IN ITA NO.1515/BANG/2012 CONFIRMING THE ORDER OF THE APPELLATE COMMISSIONER AND CONFIRM THE ORDER

PASSED BY THE DY. COMMISSIONER OF INCOME TAX, CIRCLE-11(5), BANGLORE.

THIS ITA COMING ON FOR ADMISSION THIS DAY, **MOHAN M. SHANTANAGOUDAR J.**, DELIVERED THE FOLLOWING:

JUDGMENT

This appeal is directed against the orders passed by the Income Tax Appellate Tribunal (hereinafter referred to as 'ITAT'), Bangalore Bench "C" in ITA No.1515/Bang/2012, 02.05.2014 confirming the order of the Appellate Commissioner and the order passed by the Deputy Commissioner of Income Tax, Circle-11(5), Bangalore.

2. The respondent-assessee is an undertaking of Government of Karnataka engaged in financing industrial units. During the assessment year 2009-10, the assessee had made investments to the tune of Rs.1,24,04,17,118/- in securities on which it earned dividend income of Rs.2,51,95,563/-.

The assessee company filed its return of income for the assessment year 2009-10 declaring "NIL" income. The case was taken up for scrutiny and the assessment was completed under Section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as the 'Act') by the order dated 21.11.2011 determining the loss of assessee at Rs.1,73,60,760/-. As per the provisions of Section 115 JB

of the Act, “the book profit” was determined at Rs.30,01,07,991/- by making certain additions and disallowance.

By the assessment order dated 21.11.2011, the Assessing Officer observed that while 75% of the investments were made through funds given by the Government of Karnataka, the remaining 25% were made out of the mixed pool of funds and therefore 25% of the interest expenditure was taken as indirect expenditure liable for disallowance under Section 14A of the Act read with Rule 8D of the Income Tax Rules, 1962 (hereinafter referred to as the ‘Rules’). As the amount of disallowance exceeded the amount of exempt income itself, the Assessing Officer adopted a sum of 5% of the indirect expenditure together with 0.5% of the average investments under Rule 8D(2)(iii) totaling to Rs.1,52,33,785/- as disallowance under Section 14A read with Rule 8D of the Rules.

On appeal, by the assessee, before the Appellate Commissioner, the Appellate Authority deleted the addition of 5% of the indirect expenditure on the ground that the Assessing Officer failed to establish direct nexus between the borrowed funds and tax free investment. Further, regarding disallowance of 0.5% of the average investments as

aforementioned (supra), the Appellate Commissioner directed the Assessing Officer to verify as to whether double addition was made on this account, since the assessee had contended that it had already disallowed an identical amount in its computation of income filed in the return of income.

The ITAT, by its order dated 02.05.2014 affirmed the order passed by the Appellate Commissioner concluding that the disallowance made by the Assessing Officer was not in accordance with the provisions of Rule 8D(2)(ii) of the Rules. It further observed that the Assessing Officer has failed to specify as to why 5% was adopted and as to what is the basis to arrive at that figure and consequently has failed to justify that it was an appropriate estimation. The Tribunal, having concluded that as the disallowance was made by the Assessing Officer on an adhoc percentage without any basis and without assigning any reason whatsoever, upheld the order passed by the Appellate Commissioner.

3. Before proceeding further, it is relevant to note the provisions of Section 14A of the Act and Rule 8D of the Rules, which read thus:

Section 14A of the Act:

“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.

(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.”

Rule 8D of the Rules:

“Method for determining amount of expenditure in relation to income not includible in total income.

8D - (1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

(a) the correctness of the claim of expenditure made by the assessee; or

(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, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).

(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely:-

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely:-

$$\frac{A \times B}{C}$$

Where A = amount of expenditure by way of Interest other than the amount of interest included in clause(i) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the

first day and the last day of the previous year;

(iii) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

(3) For the purposes of this rule, the "total assets" shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets."

4. Sri K.V.Aravind, learned counsel appearing on behalf of the Revenue taking us through the material on record contends that the orders passed by the Appellate Commissioner as well as the ITAT are liable to be set aside.

We are unable to accept the said contention of the learned counsel for the Revenue. On going through the orders passed by the authorities below, we find that the Appellate Commissioner and the Tribunal are justified in setting aside the orders passed by the Assessing Authority relating to disallowance. We also find that the Appellate Commissioner as well as the Tribunal are justified in concluding that the disallowance of Rs.1,03,08,426/- being a sum of 5% of indirect expenditure is not in accordance with the provisions of Rule 8D(2)(ii). Though the Assessing Officer computed the disallowance purportedly under Rule 8(2)(ii),

the amount so worked out was admittedly more than the exempt income. Therefore, the Assessing Officer has proceeded to make disallowance at 5% of the total indirect interest expenditure. It is not specified by the Assessing Officer as to why 5% was adopted and has failed to justify that the same is appropriate estimation. As the disallowance was made on an adhoc percentage without any basis or assigning any reason whatsoever, the disallowance was rightly set aside by the Appellate Authorities. As per the provisions of Section 14A of the Act, the Assessing Officer shall determine the amount of expenditure incurred in relation to exempt income which does not form part of the total income, if he was not satisfied with the correctness of the claim of the assessee in respect of such expenditure. It is settled principle of law that the Assessing Officer is required to record the non-satisfaction of the correctness of the claim. In the absence of such recording of non-satisfaction, the disallowance is untenable. In the case on hand, we do not find any such finding given by the Assessing Officer in the order of assessment for the assessment year 2009-10.

5. As regards the issue of computation of the expenditure, Rule 8D of the Rules contains three limbs, namely:-

- i) Expenditure directly related to the earning of exempt income;
- ii) Interest expenditure not directly attributable to any particular income; and
- iii) Amount equal to one-half percent of the average value of investments, income from which does not form part of total income.

As regards the 1st and 3rd limbs of Rule 8D mentioned *supra*, there is no dispute in this matter. As regards the interest referred to in the second limb of Rule 8D of the Rules, the assessee contends that the amounts of investment in such securities in the period under consideration is much less than the amount of capital and surplus funds available with the Company and no portion of the borrowed funds were utilized to make such investments. It is now well settled principle that the disallowance towards interest is not tenable if the investments are made out of own funds or non-interest bearing funds and it is necessary to establish a nexus between the interest bearing funds in investments made. Therefore, the Appellate Authorities have rightly set aside the order passed by the Assessing Officer, which does not establish nexus between the investments and interest bearing funds.

6. Insofar as disallowance made by the Assessing Officer towards provision of gratuity is concerned, the authorities, on the basis of the settled principles of law, as declared by the Courts' of law have held that, the estimation of out flow is based on actuarial valuation. Since the estimation of outflow is based on actuarial valuation, the authorities are justified in setting aside the order passed by the Assessing Officer, who has held contrary to the aforementioned settled principle of law.

7. We find that the Appellate Authority as well as the Tribunal have considered all the relevant records and on facts have arrived at a correct conclusion. Hence, no interference is called for, more particularly, when the orders passed by the Appellate Commissioner as well as the ITAT are just and proper. No substantial question of law arises for consideration.

Accordingly, the appeal fails and the same stands ***dismissed.***

Sd/-
JUDGE

Sd/-
JUDGE

TL