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**IN THE HIGH COURT OF KARNATAKA
DHARWAD BENCH**

DATED THIS THE 28TH DAY OF MAY 2018

PRESENT

THE HON'BLE DR. JUSTICE VINEET KOTHARI

AND

THE HON'BLE DR. JUSTICE H. B. PRABHAKARA SASTRY

ITA Nos.100001/2018 & 100002/2018

BETWEEN:

M/s. PRAGATHI KRISHNA GRAMIN BANK,
HEAD OFFICE, NO.32,
SANGANAKAL ROAD,
GANDHI NAGAR,
BELLARY-583103.
REPRESENTED BY ITS,
GENERAL MANAGER,
SRI S J F RAVINDRANATH,
AGED: 56 YEARS,
S/O: SRI S S J VEDANAYAKAM.

...APPELLANT

(BY SRI H.R.KAMBIYAVAR & SRI S.PARTHASARATHI, ADVS.)

AND:

THE JOINT COMMISSIONER
OF INCOME TAX,
BELLARY RANGE, BELLARY,
STAFF ROAD, FORT,
BELLARY-583102.

...RESPONDENT

(BY SRI Y.V. RAVIRAJ, ADVOCATE)

Date of Judgment: 28.05.2018
ITA Nos.100001/2018 & 100002/2018
M/s Pragathi Krishna Gramin Bank
Vs. The Joint Commissioner

THESE APPEALS ARE FILED UNDER SECTION 260A OF THE INCOME TAX ACT, 1961, PRAYING TO: (A) FORMULATE THE SUBSTANTIAL QUESTIONS OF LAW STATED ABOVE (B) ALLOW THE APPEAL AND SET ASIDE THE ORDER OF THE INCOME TAX APPELLATE TRIBUNAL DATED 03.08.2017 BEARING ITA NOS.11 & 12/BANG/2016 FOR THE ASSESSMENT YEARS 2011-12 & 2012-13 AND ETC.

THESE APPEALS COMING ON FOR ADMISSION THIS DAY, **DR. VINEET KOTHARI, J.**, DELIVERED THE FOLLOWING:

J U D G M E N T

Mr. H.R.Kambiyavar & Mr.S.Parthasarathi, Advs. for appellant-Assessee.

Mr. Y.V. Raviraj, Adv. for respondent-Revenue.

1. These Income Tax Appeals have been filed by the assessee M/s. Pragathi Krishna Gramin Bank, Bellary, against the Joint Commissioner of Income Tax, Bellary, being aggrieved by the order passed by the learned Income Tax Appellate Tribunal, Bangalore Bench "B" on **03.08.2017** in ITA Nos.11 & 12/Bang/2016 for Assessment Years **2011-12** and **2012-13**.

2. The following two issues which arise from the order of the Income Tax Appellate Tribunal and from

which the following substantial questions of law arise and they are answered as under;

- (i) Whether the Assessing Authority as well as the Appellate Authorities were justified in disallowing the expenditure incurred for earning an income exempted under Section 14A of the Income Tax Act, 1961 r/w Rule 8D of the Income Tax Rules for both the aforesaid Assessment Years 2011-12 & 2012-13, in excess of the expenditure incurred by the assessee?
- (ii) Whether the authorities below were justified in disallowing the excess claim of deduction under Section 36(1) (viii) of the Act in the hands of the assessee who carries on the eligible business of banking over and above “profits and gains of business or profession” (before making any deduction under this Clause) carried to such Reserve Account by adding back the

Depreciation and Amortization of the SLR investment made by the assessee bank during the period in question as per statutory requirements?

We take up the issue first relating to 14A of the Act.

Disallowance under Section 14A Expenditure incurred to earn exempted income:

3. The relevant findings of the assessing authority for the Assessment Year **2011-12** at Assessment order Annexure-B dated **30.01.2014** are narrated below for reference;

“8. It is seen that the assessee has income by way of **dividends of Rs.1,80,30,965/-** which has been claimed exempt. It is stated that no separate accounts have been maintained for earning exempted income. It is seen that the assessee has not disclosed any expenses towards earning the exempted income, even though **expenses have been made and interest bearing funds utilized.** Therefore,

not being satisfied with the correctness of the claim of the assessee that no expenditure has been incurred towards earning the said exempt income. The assessee was asked to explain why disallowance as per Section 14A read with rule 8D should not be made. The assessee has worked out the disallowance to be made as per Section 14A read with Section 8D at Rs.2,48,85,000/- which is as under.

“Rule 8D: Method for determining amount of expenditure in relation to income not includible in total income.

2 The expenditure in relation to income which does not form part of the total income shall be aggregate of the following amounts in (i) (ii) and (iii).

2(i) The amount of expenditure directly relating to income which does not form part of total income.

NIL

2(ii) where there is expenditure by way of interest not directly attributable to any particular income or receipt, an amount calculated in accordance with the following formula.

$A \times B / C$ = where A, B and C are as per definition given below..

$$\frac{A \times B}{C} = \frac{\text{Rs.}313.73 \text{ crores} \times \text{Rs.}44.22 \text{ crores}}{\text{Rs.}6124.94 \text{ crores}} = \text{Rs.}2.265 \text{ crores.}$$

2(iii) Half percent of the average value of the investment, the income from which does not form part of the total income, as appearing in the balance sheet on the First day and Last day of the year. (0.5 % x Rs.44.22 crores = Rs.0.22 crores)

A = Expenditure by way of interest (Rs.313.73 crores)

B = Average value of the investment, income from which is exempt, on the First day and Last day of the previous year. (Rs.77.80 crores + Rs.10.64 crores = Rs.88.44 crores/2=Rs.44.22 crores)

C = Average of total assets as appearing in the balance sheet, on the First Day and Last Day of the previous year (Rs.6580.70 crores + Rs.5669.18 crores = Rs.12249.88 crores/2=Rs.6124.94 crores)

2(i)= NIL
2(ii)= Rs.2.265 crores
2(iii)= Rs.0.220 crores
TOTAL= Rs.2.485 crores

Since the income which does not form part of the total income itself is

Rs.1,80,30,965/- there is no expenditure requiring to be disallowed”.

The assessee’s explanation is untenable and requires to be rejected. As such the said sum of Rs.2,48,85,000/- being expenditure incurred towards earnings exempt income is hereby disallowed as per the provisions of Section 14A r.w.r 8D and brought to tax”.

4. Similar additions were made also for the year 2012-13. The said additions under Section 14A of the Act for both the assessment years were upheld by the first and second appellate authorities as well.

5. The learned counsel for the assessee Mr. H.R.Kambiyavar has submitted before us that Section 14A of the Act stipulates that no deductions 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 and it is for the Assessing Authority to determine the amount of

expenditure so incurred in relation to earning of such exempted income.

6. Drawing the attention of the Court towards Rule 8D of the Income Tax Rules, 1962, the learned counsel for assessee has urged that the amount of disallowance under Section 14A of the Act read with Rule 8D of the Rules, cannot exceed the total expenditure claimed by the assessee for earning such exempted income. He submitted that in the present case the assessee earned “dividend income” from the SLR investments made by it, which is exempted from income tax to the extent of Rs.1,80,30,965/- for the assessment year **2011-12** but the learned Assessing Authority vide the aforesaid order has disallowed the expenditure to the extent of Rs.2,48,85,000/- which is *exfacie* illegal and impermissible. He also submits that the expenditure incurred to earn the exempted income in the form of Dividend was really not incurred by the Bank during the

year but the said computation of expenses of Rs.2,48,85,000/- was made as per the direction of Assessing Authority in terms of Rule 8D of the Rules with a clear submission made by the assessee that no expenditure deserves to be disallowed in the hands of assessee Bank under Section 14A of the Act r/w Rule 8D of the Rules but ignoring such factual submissions as well as the provisions of law, the assessing authority has disallowed the said sum and unfortunately the Appellate Authorities have also casually upheld the said findings.

7. On the other hand, Sri Y.V.Raviraj learned counsel for the Revenue urged before the Court that though the disallowance in excess of the dividend income earned by the assessee to the extent of Rs.1,80,30,965/- may not be justified, but the assessee himself has computed the said figure of Rs.2,48,85,000/- in terms of Rule 8D of the Rules and had supplied the same to the assessing

authority and therefore the assessing authority was justified in disallowing the same.

8. We are not impressed with the said contention raised by the learned counsel for Revenue. The said disallowance, under Section 14A of the Act r/w Rule 8D of the Rules, of the expenditure incurred to earn an exempted income has to be computed in accordance with Rule 8D of the Rules, which in essence stipulates that the expenditure directly relatable to the earning of such exempted income, can only be disallowed under Section 14A of the Act.

9. The assessee in the present case had claimed that he had not incurred any expenditure for earning of the said dividend income on such statutory SLR investments made by it. The amount of investments itself cannot be considered as an expenditure for earning an exempted income *viz.*, the dividends. The

computation of disallowance under Section 14A of the Act has to be made as per Rule 3D of the Rules.

10. Therefore, on the basis of actual expenditure incurred by the assessee for earning such exempted income or an average estimated basis, on the basis of the total value of investments was required to be computed by the assessing authority. We do not find, any such computation on the part of the assessing authority in this regard. Apparently, the expenditure, so calculated to the extent of Rs.2,48,85,000/- which was disallowed by Assessing Authority is far in excess of the dividend income of Rs.1,80,30,965/-. The same prima facie appears to be incorrect. While the assessee claimed that no expenses was incurred in this regard, the assessing authority has disallowed the said expenditure even in excess of the dividend income itself. The said calculations do not appear to be computed in

accordance with Rule 8D of the Rules. We do not find any rational basis for the same.

11. The obligation is cast upon the assessing officer under Section 14A of the Act to determine the said amount of expenditure incurred for earning the exempted income of dividends.

12. The provision of Section 14A of the Act and Rule 8D of the Rules are quoted below for reference;

“Expenditure incurred in relation to income not includible in total income.

14A. (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: 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; and

(ii) an amount equal to one percent of the annual average of the monthly averages of the opening and closing balances of the value of investment, income from which does not or shall not form part of total income:

Provided that the amount referred to in clause (i) and clause (ii) shall not exceed the total expenditure claimed by the assessee]

*(3) [***]]”*

Rule 8D has been amended from time to time. The aforesaid quoted Rule is from the latest. The said Rule 8D as applicable for Assessment Years 2011-12 & 2013-14 will be relevant.

13. The manner in which the aforesaid disallowance has been made by the assessing authority and has been upheld by the appellate authorities leaves much to the desired and the same cannot be sustained and therefore the matter deserves to be remanded back to the Assessing Authority.

14. We make it clear that the expenditure for earning exempted income has to have a reasonable proportion to the income, so earned, going by the common financial prudence. Therefore, even if the Assessing Authority has to make an estimate of such an expenditure incurred to earn exempted income, it has to have a rational nexus with the amount of income earned itself. Disallowance under Section 14A of Rs.2,48,85,000/- as expenses to earn exempted Dividend income of Rs.1,80,30,965/- is per se absurd and hypothetical. The disallowance under Section 8D cannot exceed the expenses claimed by assessee under the Proviso to Rule 8D. Therefore, where

the assessee claimed that assessee did not incur any such expenditure during the year in question to earn Dividends of Rs.1,80,30,965/-, the burden was upon the assessing authority to compute the interest on such borrowed funds which were dedicatedly used for investment in securities to earn such exempted Dividend income. The disallowance under Section 14A cannot be a wild guesswork bereft of ground realities. It has to have a reasonable and close nexus with the factually incurred expenses. It is not deemed disallowance under Section 14A of the Act but an enabling provision for assessing authority to compute the same on the given facts and figures in the regularly maintained Books of Accounts. The assessing authority also could not have called upon the Assessee himself to undertake the exercise of computing the disallowance under Section 8D of the Rules. Such abdication of duty is not permissible

in law. Since no such exercise has been undertaken by the assessing authority, the case calls for a remand.

15. In this view of the matter, the findings of all the three authorities below for Section 14A of the Act are set aside and the matter is remanded back to the Assessing Authority for re-computing the disallowance of expenditure, if any, under Section 14A of the Act, in accordance with law.

Disallowance under Section 36(1)(viii) of the Act:

16. The second issue involved in the present case pertains to Section 36(1)(viii) of the Act, which arises only for the Assessment Year **2012-13**. The said provision of Section 36 (1) (viii) of the Act, provides for “Other Deductions” in Chapter IV relating to computations of “Business income” of the assessee, and it reads as under:

“Other deductions.

36. (1) *The deductions provided for in the following clauses shall be allowed in respect of the matters dealt with therein, in computing the income referred to in section 28 –*

(i) the amount of any premium paid in respect of insurance against risk of damage or destruction of stocks or stores used for the purposes of the business or profession;

(ii) xxxxx

(iii) xxxxx

(iv) xxxxx

(v) xxxxx

(vi) xxxxx

(vii) xxxxx

((viii)) in respect of any special reserve created and maintained by a specified entity, an amount not exceeding **twenty per cent of the profits derived from eligible business computed under the head “Profits and gains of business or profession” (before making any**

deduction under this clause) carried to such reserve account:

Provided that where the aggregate of the amounts carried to such reserve account from time to time exceeds twice the amount of the paid up share capital and of the general reserves of the specified entity, no allowance under this clause shall be made in respect of such excess.

Explanation. -- In this clause --

(c) "specified entity" means, -

(i) a financial corporation specified in section 4A of the Companies Act, 1956 (1 of 1956);

(ii) a financial corporation which is a public sector company;

(iii) a banking company;

(iv) a co-operative bank other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank;

(v) a housing finance company; and

*(vi) any other financial corporation
including a public company;*

17. The authorities below have held against the assessee on the said issue that in the net profit from banking business declared by the assessee, transferred to General Reserve, the assessee before claiming 20% deduction of the profits, added back the amount of amortization and depreciation in SLR investments, to arrive at a higher figure of profit for claiming the aforesaid 20% deduction under Section 36 (1) (viii) of the Act, which is not permissible.

18. The learned counsel for the Revenue urged before the Court that Section 36 (1) (viii) of the Act talks of “profits and gains of business or profession” before making any deduction under this Clause and therefore, the amortization and depreciation in SLR investments already deducted from the profit earned by the assessee

for the said year cannot be added back for the limited purpose of computing profits and gains of business or profession for the purpose of Section 36 (1) (viii) of the Act so as to claim a higher deduction of 20% under the said provisions.

19. We find considerable force in the said submission made by the counsel for the Revenue and there is no adequate rebuttal of the same by the learned counsel for the assessee.

20. The profits and gains of business or profession for the purpose of claiming deduction of 20% thereof under Section 36 (1) (viii) of the Act does not envisage any such artificial raising of the “profits” by adding back the amortization and depreciation in the SLR investments, as has been done by the assessee Bank in the present case. The profits and gains of business, as simply computed as per the accounting practices followed by

the assessee in normal course of business under Section 28 of the Act has to be the basis for computing 20% deduction. The artificial increase of the profits by adding back amortization and depreciation in SLR investments by the assessee as done by it before the assessing authority was not justified and therefore, the authorities below appear to be justified in reducing the said deduction, ignoring the said adding back of the amortization and depreciation in SLR investments. The said deduction has to be restricted to 20% of profits of banking business as computed by the assessing authority. Therefore, the contention raised by the assessee in this regard in the present appeals before us is not sustainable. The said contention, therefore, is liable to be rejected. The same is accordingly rejected.

21. The appeals filed by the assessee are accordingly ***partly allowed*** & the issue of disallowance under Section 14A of the Act read with Rule 8D of the Rules

Date of Judgment: 28.05.2018
ITA Nos.100001/2018 & 100002/2018
M/s Pragathi Krishna Gramin Bank
Vs. The Joint Commissioner

for both the assessment years is remanded back to the Assessing Authority for passing fresh orders in accordance with law within a period of one year from today.

No orders as to costs.

**Sd/-
JUDGE**

**Sd/-
JUDGE**

msr/yan