IN THE INCOME TAX APPELLATE TRIBUNAL
BANGALORE BENCHES : "A", BANGALORE

BEFORE SHRI N.V.VASUDEVAN, VICE PRESIDENT
AND
SHRI B.R.BASKARAN, ACCOUNTANT MEMBER

ITA No.1948(Bang)/2018
(Assessment Year : 2014-15)

Mphasis Software & Services (India) Pvt.Ltd.,
Bagmane World Technology Centre,
1st Floor, wing a, WTC 3, KR Puram,
Marathahalli Outer Ring Road, Mahadevapura,
Bengaluru-560 048
PAN No.AACCM5986K Appellant

Vs

The Asst. Commissioner of Income Tax Officer,
Circle-4,(1)(2),
Bangalore Respondent

Appellant by : Shri K.R.Girish, CA
Revenue by : Shri Manjeet Singh, Addl.CIT

Date of hearing : 01-07-2020
Date of pronouncement : 03-07-2020

O R D E R

***PER N.V.VASUDEVAN, VICE PRESIDENT*:**

This is an appeal by the Assessee against the order dated 29-03-2018of the ld. Commissioner of Income Tax (Appeals)–4, Bangalore relating to AY: 2014-15. In this appeal the only issue that arises for consideration is as to whether the revenue authorities were justified in making a disallowance of a sum of Rs.41,48,681/- as expenditure incurred in earning exempt income by invoking the provisions of Sec.14A of the Income Tax Act, 1961 (Act). The proceedings in question were proceedings initiated u/s 154 of the Act.

2. The Assessee is a Pvt.Ltd., Company engaged in rendering Software Development Services and Information Technology support services. For AY:

2014-15 the Assessee filed its return of income. During the relevant previous year the Assessee earned dividend income from mutual funds amounting to Rs.4,04,38,466/- which was exempt income from tax u/s 10(38) of the Act. As per the provisions of Sec.14A of the Act, any expenditure incurred in earning income which does not form part of the total income under Chapter III of the Act, has to be disallowed and added to the total income. The Assessee computed administrative expenses amounting to Rs.3,55,660/- against the exempt dividend income and disallowed the same u/s14A of the Act.

3. The Assessee's case for the year under consideration was selected for scrutiny assessment and notice under sec.143(2) of the Act dated 29th August 2015 was issued by the AO. The AO passed order dated 25th November 2016 under section 143(3) of the Act accepting the income declared by the Assessee. Thus, the AO also accepted the disallowance made y the company u/s 14A of the Act amounting to Rs.355,6660/-.

4. Subsequently, the AO initiated rectification proceedings under sec.154 of the Act vide notice dated 4th December 2017 proposing to rectify the following alleged mistake. According to the AO, it was noticed from the assessment records that the Assessee has claimed and allowed exemption of dividend income u/s 10(34) amounting to Rs.4,04,38,466/- while computing the income from business. The Assessee had claimed expenses towards interest on term loan as financial expenses. However, the Assessee ought to have disallowed expenses u/s 14A of the Act, r.w.Rule 8D(2)(iii) of the Income Tax Rules 1962 (Rules) of Rs.45,04,341/-. A notice u/s.154 of the Act, was issued to the Assessee accordingly.

5. The Assessee vide letter dated 11th December2017 sought some time from the AO to respond to the notice dated 4th December, 2017 issued u/s 154 of the Act. According to the Assessee, the AO without providing any opportunity of being heard passed order u/s 154 of the Act dated 17-01-2018 wherein he worked out the disallowance u/s 14A of the Act in accordance with Rule 8D(2)(iii) of the rules and arrived at a sum of Rs.4,504,341/- as sum that has to be disallowed u/s 14A of the Act and added to the total income of the

Assessee. Since the Assessee had already offered a sum of Rs.355,660/- as disallowance u/s.14A of the Act, the AO in his order u/s 154 of the Act disallowed Rs.41,48,681/- being the difference between Rs.45,04,341 and Rs.3,55,660/- u/s 14A of the Act and added the same to the total income of the Assessee.

6. Against the said order dated 17.1.2018, the Assesee filed appeal before CIT(A). Before the ld. CIT(A) the Assessee firstly submitted that the Assessee was not given an opportunity of being heard and the order of the AO was in violation of principles of natural justice and therefore, has to be quashed. The second submission by the Assessee was that the issue as to what is the quantum of disallowance that has to be made u/s 14A of the Act is a debatable issue. The AO has to arrive at a satisfaction that the methodology of disallowance u/s 14A of the Act adopted by the Assessee was incorrect in the light of the books of accounts of the Assessee and only then he can proceed to invoke Rule 8D(2)(iii) of the Rules. In this regard it was argued by the Assessee that the debatable issue are outside the purview of rectification proceedings u/s 154 of the Act and in this regard he relied on the decision of the Hon'ble Supreme Court in the case of T.S.Balaram Vs Volkart Bros.(1971) 82 ITR 50(SC).

7. Besides the above, the Assessee also gave the basis of disallowance made by it in the return of income by pointing that the Assessee has suo-moto disallowed expenses u/s 14A of the Act amounting to Rs.355,660/- against the exempt dividend income of Rs.40,438,466/-. The Assessee has already considered all related administrative expenses incurred by it for managing the investment from which exempt income was earned and hence additional disallowance as per Rule 8D is not called for. The Assessee submitted that the treasury team of the Assessee manages all the investment made by the India group company namely, Mphasis Ltd., MSource India Pvt.Ltd. and MPhasis software and Solution India Ltd., in addition to the other work of forex management, hedging, payment settlement, etc. of the entire India group company. The Assessee follows the policy of disallowing entire salary cost

incurred on the treasury tam and also allocable overhead cost on treasury team u/s 14A in proportion to the average opening and closing investment held by the Indian group companies. The Assessee submitted that the treasury team is engaged in managing other affairs of the group companies in addition to Assessee work responsibility of managing the investment of the group companies. Even in such circumstances, the Assessee disallows entire salary and administrative cost incurred on the treasury team on conservative basis u/s 14A instead of disallowing the expenses in proportion of work performed by them for managing the investment from which exempt income is earned. It was thus submitted that the Assessee has duly considered all the expenses that could reasonably be attributed to the earning of the exempt dividend income and that too on the conservative basis of disallowing the expenses then actually required to be. The computation of sec.14A disallowance on the methodology is explained in the chart annexed to this order.

8. The CIT(A) however, did not agree with the submission of the Assessee. He proceeded to hold that the issue was not debatable and the disallowance u/s 14A of the Act had to be worked out in the manner prescribed by Rule 8D(2)(iii) of the Rules on the basis of figures already available on record. He was of the view that the issue of disallowance u/s 14A r.w.rule 8D(2)(ii) involves examination of fund flow and application of borrowed funds and therefore, it would be a debatable issue, but disallowance under rule 8D(2)(iii) had to be made only by considering the facts and figures and was not a debatable at all. He also held that the Assessee has not given any basis for the suo-moto disallowance of Rs.355,660/- u/s 14A of the Act. In other words, the conclusion of the ld.CIT(A) was that once the disallowance made by an Assessee in not accordance with Rule-8D(2)(iii) of the rules than the disallowance has to be made only in accordance with the said rules. The ld. CIT(A) thus rejected the claim of Assessee and confirmed the order of AO.

9. Aggrieved by the order of the ld. CIT(A) the Assessee has preferred the present appeal before the Tribunal. We have heard the submissions of the ld.counsel for the Assessee who reiterated the stand as was taken before the

lower authorities. He also placed reliance on the decision of the Hon’ble Supreme Court in the case of CIT Vs Maxopp Investments Ltd. 402 ITR 640(SC) wherein the Hon’ble Supreme Court took the view that the AO has to record a satisfaction with regard to in-correctness of suo-moto disallowance made u/s 14A of the Act and record his satisfaction in this regard. The ld. DR relied on the order of the ld. CIT(A). We have carefully considered the rival submissions.

10. By the Finance Act of 2001, Parliament enacted section 14A with retrospective effect from April 1, 1962. Section 14-A of the Act so enacted provided that in computing the total income of an assessee, 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." The Memorandum Explaining the Provisions in the Finance Bill of 2001 provided the following rationale for the insertion of section 14A ([2001] 248 ITR (St.) 192, 195, 196) :

> "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.
>
> It is proposed to insert a new section 14A 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.
>
> The proposed amendment will take effect retrospectively from April 1, 1962 and will accordingly, apply in relation to the assessment year 1962-63 and subsequent assessment years."

11. Sub-sections (2) and (3) of section 14A were inserted by an amendment brought about by the Finance Act of 2006 with effect from April 1, 2007. Sub-sections (2) and (3) provide as follows :

> "14A.(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 circumstances in which the provisions of sub-sections (2) and (3) were introduced by an amendment have been adverted to in a circular of the Central Board of Direct Taxes dated December 28, 2006 (Circular No. 14 of 2006-[2006] 288 ITR (St.) 9). The circular notes that in the existing provisions of section 14A no method for computing the expenditure incurred in relation to income which does not form part of the total income had been provided. As a result there was a considerable dispute between taxpayers and the Revenue on the method of determining such expenditure. In this background, sub-section (2) was inserted so as to make it mandatory for the Assessing Officer to determine the amount of expenditure incurred in relation to income which does not form part of the total income in accordance with the method that may be prescribed. The circular, however, reiterates that the Assessing Officer has to follow the prescribed method if he is not satisfied with the correctness of the claim of the Assessee having regard to the accounts of the Assessee.

13. Rule 8D was inserted by the Income-tax Act (Fifth Amendment) Rules, 2008, which were published in the Gazette on March 24, 2008. The rules specifically provide that they shall come into force from the date of their publication in the Official Gazette. The provisions of section 14A as originally introduced and as amended from time to time as well as the insertion of Rule 8D was subject-matter of several decisions rendered by various Benches of the ITAT as well as the Hon'ble High Courts. The Hon'ble Delhi High Court in the case of *Maxopp Investments Ltd. v. CIT 2011) 203 Taxman 364 (Del)* and the Hon'ble Bombay High Court in the case of *Godrej & Boyce Mfg. Co. Ltd. 328 ITR 81 (Bom)* have taken a view that Rule 8D of the I.T. Rules will apply only for A.Ys. 2008-09 and subsequent assessment years. It has also been laid down that the Assessee has to make a claim (including a claim that no expenditure was incurred) with regard to expenditure incurred for earning income which is not chargeable to tax. Such a claim has to be examined by the AO and only if on an objective satisfaction arrived at by the AO that the claim made by the Assessee is not correct, can the AO proceed to apply the computation mode as specified in Rule 8D(2) of the Rules. In **Maxopp** Investment Ltd v/s CIT 402 ITR 640 (SC) the Hon'ble Supreme Court after considering several decisions of the Hon'ble High Courts on the issue of disallowance u/s.14A culled out certain principles, some of those principles relevant to the present case are that as per section14A(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 expenditure would then be considered as incurred in respect of other income which is to be treated as part of the total income. The principle of apportionment of expenses is the principle which is engrained in Section 14A of the Act. Having regard to the

language of Section 14A(2) of the Act, read with Rule 8D of the Rules, before applying the theory of apportionment, the AO needs to record satisfaction that having regard to the kind of the Assessee, suo moto disallowance under Section 14A was not correct. 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.

14. In the present case, the Assessee has taken a stand that expenditure was incurred to earn exempt income was only Rs.3,55,660. The AO has to follow the mandate laid down in Sec.14A(2) of the Act, i.e., he has to examine the claim of the Assessee in the light of the books of accounts of the Assessee. If the AO does not agree with the claim of the Assessee having regard to the books of accounts of the Assessee, then is it mandatory for him to resort to Rule 8D of the Income Tax Rules, 1962 to quantify the disallowance u/s.14A of the Act? We are of the view that even in a case where the AO rejects the claim of the Assessee regarding expenses incurred to earn the exempt income, it is not mandatory for him to invoke the method of calculation prescribed by Rule 8D(2) of the Rules and is free to make the disallowance on any reasonable basis. The second part of Sec.14A(2) of the Act provides as follows, "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". In other words, it is only when no reasonable and proper parameters for making disallowance can be arrived at, that resort to Rule 8D(2) can be had by the AO. Rule 8D(2) will thus be a last resort when it becomes impossible to arrive at a just conclusion on the amount of expenses that has to be disallowed as attributable or incurred in earning exempt income. Therefore the expression "shall" occurring in Sec.14A(2) of the Act, viz., "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", should be read as **"may".** The AO, u/s 14A of the Act has the discretion to

substitute the computation of disallowance u/s 14A as made by the Assessee on estimation. The satisfaction contemplated u/.s 14A (2) of the Act is not merely restricted to rejecting the claim made by the Assessee and the disallowance to be made u/s 14A of the Act but also includes substituting the claim made by the Assessee on any other reasonable basis as the AO deems it fit. In such circumstances the correctness of the AO's judgment can be reviewed but it cannot be said that the AO had no jurisdiction to do so and AO ought to resort only to the provision of Rule 8D of the Rules. In other words Rule 8D is not automatic and can be resorted to by the AO only as a measure of last resort.

15. In view of the aforesaid legal position with regard to disallowance u/s 14A of the Act, we are of the view that the issue before the AO was debatable and therefore, resort to proceedings u/s 154 of the Act was not appropriate. We therefore, hold that the proceedings u/ 154 of the Act were not appropriate and accordingly the same is quashed.

16. In the result, the appeal of the Assessee is allowed.

Order pronounced on 03-07-2020

Sd/-	Sd/-
(B.R.BASKARAN)	**(N.V.VASUDEVAN)**
ACCOUNTANT MEMBER	**VICE PRESIDENT**

<u>Encl</u>: Annexure-I

Place: Bangalore
Dated: 03-07-2020
***am**
Copy of the Order forwarded to:
1.Appellant;
2.Respondent;
3.CIT;
4.CIT(A);
5.DR
6.Guard File

By Order

Asst.Registrar