

**IN THE INCOME TAX APPELLATE TRIBUNAL
DELHI BENCH: 'F' NEW DELHI**

**BEFORE SHRI BHAVNESH SAINI, JUDICIAL MEMBER
AND
SHRI O.P. KANT, ACCOUNTANT MEMBER**

ITA No.682/Del./2017
Assessment Year: 2012-13

Addl. CIT, Special Range-7, New Delhi	Vs.	PNB Gilts Ltd., 5, Sansad Marg, New Delhi
PAN :AAACP7685B		
(Appellant)		(Respondent)

Appellant by	Smt. Sushma Singh, CIT(DR)
Respondent by	Ms. Sana Baqai, CA

Date of hearing	05.03.2020
Date of pronouncement	01.05.2020

ORDER

PER O.P. KANT,A.M.:

This appeal by the Revenue is directed against order dated 25/11/2016 passed by the Learned CIT(Appeals)-7, New Delhi [in short 'the Ld. CIT(A)'] for assessment year 2012-13 raising following grounds:

1. *On the facts and in the circumstances of the case, the Ld. CIT(A) has erred in deleting disallowance of Rs.3,92,60,000/- u/s 14A of the Income Tax Act, 1961.*
2. *On the facts and in the circumstances of the case, the Ld. CIT(A) has erred in deleting disallowance of Rs.30,61,000/- u/s 36(i)(iii) of the Income Tax Act, 1961.*
3. *On the facts and in the circumstances of the case, the Ld. CIT(A) has erred in deleting disallowance of Rs.6,56,24,000/- on account of provision for diminution in market value of stock in trade.*

4. *The appellant craves to be allowed to add any fresh ground(s) of appeal and/or delete or amend any of the ground(s) of appeal.*

2. Briefly stated facts of the case are that the assessee, a Non-Banking Financial Company (NBFC) , filed its return of income on 20/09/2012 declaring total income of ₹ 25,77,78,259/-. The return of income filed was selected for scrutiny assessment , which was completed under section 143(3) of the Income-tax Act, 1961(in short 'the Act') on 02/03/2015 after making certain addition/disallowances. Aggrieved, the assessee filed appeal before the Ld. CIT(A), who partly deleted the addition/disallowances which were made by the Assessing Officer. Aggrieved, the Revenue is in appeal before the Tribunal raising the grounds as reproduced above.

3. The ground No. 1 of the appeal relates to disallowance of ₹ 3,92,60,000/-made under section 14A of the Act, which has been deleted by the Ld. CIT(A).

3.1 The brief facts qua the issue in dispute are that during the year, the assessee received dividend income of ₹ 4,78,249/-from investment including shares which were held as stock-in-trade. The assessee also received interest on bonds amounting to ₹ 4,15,80,043/-. Both the amount of dividend and interest were claimed by the assessee as exempt. In the return of income, no disallowance of expenses was made by the assessee for earning such exempt income. However, on being questioned by the Assessing Officer for disallowance of expenditure under section 14A, the assessee without prejudice to claim that no disallowance was called for, submitted working of disallowance which could be made under section 14A read with rule 8D of Income Tax Rules, 1962 (in short the Rules) , as under:-

- (i) direct expenditure [under rule 8D(2)(i)]- – NIL
- (ii) apportioned indirect interest expenses [under rule 8D(2)(ii)]- nil- (The assessee contended that entire interest expenses have been incurred towards: short notice money borrowing, CBLO borrowing, Repo borrowings, RBI borrowings, Overdraft borrowing, ICD borrowing. According to the assessee all the borrowings utilised for the purpose of the business and thus no disallowance is called for.)
- (iii) 0.5% of average investment(under rule 8D(2)(iii) : ₹ 34.5 lakhs

3.2 The Assessing Officer, however, did not accept the contention of the assessee regarding disallowance under rule 8D(2)(ii) of the rules. According to the Assessing Officer, the assessee has made investment in assets yielding exempt income out of the borrowings and therefore disallowance under rule 8D(2)(ii) for proportionate interest towards investment in assets yielding exempt income was justified. The Assessing Officer computed such disallowance ₹ 392.62 lakhs and after adding disallowance of ₹ 34.25 lakhs under rule 8D(2)(iii) of the rules, made total addition of ₹ 426.85 lakhs. The Ld. CIT(A) deleted the disallowance under rule 8D(2)(ii) observing as under:

“4.4 The AO invoked provisions of Section 14A read with Rule 8D of the I.T. Rules, 1962 and relied on Circular No. 5/2014 dated 11.02.2014 of CBDT and computed disallowance at Rs.426.85 lacs constituted of Rs.392.62 lacs as per Rule 8D(2)(ii) and Rs.34.25 lacs as per Rule 8D(2)(iii). The Ld. AR has contended that as the securities/bonds and scrips is held as stock in trade, no amount of interest can be attributed to the acquisition of these scrips/securities and bonds on which exempt income is earned and therefore, disallowance under Rule 8D(2)(ii) is not called for. Reliance is placed

on the decision in the case of CCI Ltd. Vs. JCIT 20 Taxman 196(Kar.) in which the Hon'ble Karnataka High Court held that exempt income earned on stock in trade will not attract disallowance u/s 14A. The Ld. CIT(Appeals) vide her order in appeal for A.Y. 2011-12 had also held that disallowance under Rule 8D(2)(ii) was not attracted as the appellant held the securities, as stock in trade. It is also noted that the appellant had interest free funds by way of share capital and reserve and surplus of Rs.577.64 lacs whereas the average investment in stock in trade from which exempt income is earned is at Rs.6850.45 lacs only. In the case of CIT vs. Rliance Utilities and Power Ltd. 313 ITR 340, it was held that if there is sufficient interest free funds available, it can be presumed that the investments were made from such funds. Similarly, in the case of CIT vs. HDFC Bank Ltd., the Hon'ble Bombay High Court that in case the assessee's own funds were more than the investments in tax free securities, it would have to be presumed that the investment made by the assessee would be out of interest free funds available with the assessee. In view of the judicial pronouncements referred above, facts of the case and following the decisions of the Ld. CIT(Appeals) in the case of the appellant for A.Y. 2011-12, disallowance of Rs.34.25 lacs as per Rule 8D(2)(iii) which is conceded by the Ld. AR, is sustained and balance disallowance of Rs.392.60 lacs under Rule 8D(2)(ii) is deleted. This ground of appeal is partly rules in favour of the appellant."

3.3 Before us, the learned DR submitted that the decision in the case of Hon'ble Karnataka High Court, which has been relied upon by the Ld CIT(A) to hold that exempt income earned on stock-in-trade will not attract disallowance u/s 14A of the Act is no longer a valid law in view of the decision of the Hon'ble Supreme Court in the case of Maxopp Investment Ltd. reported in 402 ITR 640 (SC).

3.4 On the other hand, the Learned Counsel of the assessee filed a paper book containing page 1 to 162 and submitted that issue in dispute has been decided in favour of the assessee by the Tribunal in ITA No. 810/Del/2015 for assessment year 2010-11.

3.5 On the issue of own funds sufficient to make investment in assets yielding exempt income, the Learned Counsel referred to page 29 of the paper-book and submitted that total share capital

and reserve and surplus was of Rs. 577.64 crores(wrongly mentioned by the Learned CIT(A) as ₹ 577. 64 lakhs) which is in excess of average investment in a stock-in-trade of Rs. 68.50 Crores, income from which was exempt of and thus no disallowance could have been made under rule 8D(2)(ii) of the Income-tax Rules.

3.6 We have heard rival submission of the parties on the issue in dispute. Though in assessment year 2011-12 the issue in dispute has been decided by the Tribunal in favour of the assessee , but in view of the decision of the Hon'ble Supreme Court in the case of Maxopp investment Ltd (supra), cited by the learned DR, the issue in the year under consideration need to be reconsidered. The Ld. CIT(A) has deleted the disallowance under rule 8D(2)(ii) amounting to ₹ 392.6 lakhs on two grounds.

3.7 First ground being the exempt income earned on stock-in-trade will not attract disallowance under section 14A of the act in view of the decision of the Hon'ble Karnataka High Court in the case of CCI Ltd Vs JCIT (supra). However, Hon'ble Supreme Court in the case of Maxopp Investment Ltd (supra) after considering the decision of the Hon'ble Karnataka High Court in the case of CCI Ltd (supra) held as under :

“36) There is yet another aspect which still needs to be looked into. What happens when the shares are held as ‘stock-in-trade’ and not as ‘investment’, particularly, by the banks? On this specific aspect, CBDT has issued circular No. 18/2015 dated November 02, 2015.

37) This Circular has already been reproduced in Para 19 above. This Circular takes note of the judgment of this Court in Nawanshahar case wherein it is held that investments made by a banking concern are part of the business or banking. Therefore, the income arises from such investments is attributable to business of banking falling under the head ‘profits and gains of business and profession’. On that basis, the Circular contains the decision of the

Board that no appeal would be filed on this ground by the officers of the Department and if the appeals are already filed, they should be withdrawn. A reading of this circular would make it clear that the issue was as to whether income by way of interest on securities shall be chargeable to income tax under the head 'income from other sources' or it is to fall under the head 'profits and gains of business and profession'. The Board, going by the decision of this Court in Nawanshahar case, clarified that it has to be treated as income falling under the head 'profits and gains of business and profession'. The Board also went to the extent of saying that this would not be limited only to co-operative societies/Banks claiming deduction under [Section 80P\(2\)\(a\)\(i\)](#) of the Act but would also be applicable to all banks/commercial banks, to which [Banking Regulation Act](#), 1949 applies.

38) From this, Punjab and Haryana High Court pointed out that this circular carves out a distinction between 'stock-in-trade' and 'investment' and provides that if the motive behind purchase and sale of shares is to earn profit, then the same would be treated as trading profit and if the object is to derive income by way of dividend then the profit would be said to have accrued from investment. To this extent, the High Court may be correct. At the same time, we do not agree with the test of dominant intention applied by the Punjab and Haryana High Court, which we have already discarded. In that event, the question is as to on what basis those cases are to be decided where the shares of other companies are purchased by the assesseees as 'stock-in-trade' and not as 'investment'. We proceed to discuss this aspect hereinafter.

39) In those cases, where shares are held as stock-in-trade, the main purpose is to trade in those shares and earn profits therefrom. However, we are not concerned with those profits which would naturally be treated as 'income' under the head 'profits and gains from business and profession'. What happens is that, in the process, when the shares are held as 'stock-in-trade', certain dividend is also earned, though incidentally, which is also an income. However, by virtue of [Section 10](#) (34) of the Act, this dividend income is not to be included in the total income and is exempt from tax. This triggers the applicability of [Section 14A](#) of the Act which is based on the theory of apportionment of expenditure between taxable and non-taxable income as held in Walfort Share and Stock Brokers P Ltd. case. Therefore, to that extent, depending upon the facts of each case, the expenditure incurred in acquiring those shares will have to be apportioned.

40) We note from the facts in the State Bank of Patiala cases that the AO, while passing the assessment order, had already restricted the disallowance to the amount which was claimed as exempt income by applying the formula contained in Rule 8D of the Rules and holding that [section 14A](#) of the Act would be applicable. In spite of

this exercise of apportionment of expenditure carried out by the AO, CIT(A) disallowed the entire deduction of expenditure. That view of the CIT(A) was clearly untenable and rightly set aside by the ITAT. Therefore, on facts, the Punjab and Haryana High Court has arrived at a correct conclusion by affirming the view of the ITAT, though we are not subscribing to the theory of dominant intention applied by the High Court. 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. 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. In the result, the appeals filed by the Revenue challenging the judgment of the Punjab and Haryana High Court in State Bank of Patiala also fail, though law in this respect has been clarified hereinabove."

3.8 On the shares held as stock-in-trade , an assessee earn profit or loss on trading of the those share and additionally earn dividend also. The Hon'ble Supreme Court has directed to apportion expenses towards exempt dividend income from stock-in-trade as well as profit earned on trading of stock-in-trade and the expenses apportioned toward exempt income are only held as liable for disallowance. Accordingly , the Assessing Officer is required to apportion the part of expenses related to exempt dividend income and consider that part for disallowance only .

3.9 The second ground on which the Ld. CIT(A) has deleted the disallowance is that in view of decision in the case of CIT Vs

Reliance Utilities and Power Ltd 313 ITR 340(SC), if there are sufficient interest-free funds available, it can be presumed that investment had been made out of from such funds and thus no disallowance for interest is required. Similar finding has been given by the Hon'ble Bombay High Court in the case of CIT Vs HDFC bank Ltd (supra). The assessee has claimed that shares capital and reserve and surplus of the assessee amounting to ₹ 577.64 crores is more than the stock in trade of ₹ 68.50 crores.

3.9 But we have seen that exempt income is not only from the equity shares kept as stock-in-trade but also from interest of ₹ 4,15,80,043/-received on bonds. The same has been invested in compliance of the Reserve Bank of India (RBI) Rules. But once exempt income is earned, then interest for corresponding borrowing would be liable for disallowance. Thus, the assessee is required to demonstrate not only investment in shares had been out of interest free funds but investment in Bonds was also made out interest free own funds.

3.10 In view of the above facts and circumstances of the case , we feel it appropriate to restore this issue to the file of the learned Assessing Officer for deciding a fresh in view of our finding above and in accordance with law. The assessee shall provide all details of the investment in assets yielding exempt income as well as own funds and funds borrowed. The assessee shall also provide details of apportionment of interest expenses in relation to a stock-in-trade towards earning dividend income as well as towards earning trading profit. If the AO finds that entire investment in assets yielding exempt income has been made out of the interest free own funds , then no disallowance will be called for under rule 8D(2)(ii) and he will not be required to look into the

apportionment of the expenses towards dividend income from shares held as stock in trade. The ground No. 1 of the appeal of the Revenue is accordingly allowed for statistical purposes.

4. The ground No.2 of the appeal relates to disallowance of ₹30,61,000/-under section 36(1)(iii) of the Act.

4.1 The Assessing Officer is of the view that interest paid on short-term borrowings for the equity shares held as a stock in trade, dividend income from which has been claimed as exempt, is not allowable in terms of section 36(1)(iii) of the Act being incurred not for business purposes. The Assessing Officer considered the amount of ₹ 31.61 lakhs as excessive interest payment for disallowance. The Ld. CIT(A) deleted the disallowance following finding of his predecessor in assessment year 2011-12 observing as under:

“The AO computed disallowance u/s 36(1)(iii) of the Act at Rs.30.61 lacs on the grounds that the borrowed funds were not utilized for the purpose of business. He was of the view that payment of interest to the extent or borrowed funds utilized as investment in interest free securities, does not qualify for eligible expense as per Section 36(1)(iii) of the Act. The Ld. AR has contended that the disallowance u/s 36(1)(iii) of the Act can be made only when the borrowed capital is not utilized for business purposes. The AO has not denied that the borrowed capital is used to purchase the securities held as stock in trade by the appellant. His basic premise for disallowing the interest is that the appellant acquired securities on which it earned interest which was claimed as exempt and therefore, expenditure on interest to that extent was for non-business purpose. The company has earned total interest income of Rs.100.39 crores out of which interest income of Rs.4.16 crores is tax free. Since the securities/bonds on which interest income is earned, is held as stock in trade, interest expenditure is relatable to the business of the appellant and therefore, allowable. Similar finding is recorded by the Ld. CIT(A) in Appeal for A.Y. 2011-12. Since the facts are similar, following the decision of the Ld. CIT(A), it is held that the interest expenditure of Rs.30.61 lacs is allowable as per provisions of Section 36(1)(iii) of the Act. The addition of Rs.30.61 lacs is directed to be deleted. This ground of appeal is ruled in favour of the appellant.”

4.2 We have heard rival submission of the parties on the issue in dispute. This issue has been decided in favour of the assessee by the Tribunal in assessment year 2011-12, but in view of the decision of the Hon'ble Supreme Court in the case of Maxopp investment Ltd (supra), the issue requires reconsideration. It is undisputed that any expenditure related to exempted income cannot be allowed under the head profit in gains of the business. Under the head profit in gains of the business expenses related to the business income are only to be allowed as per the provisions of the Act. In the instant case, the assessee has claimed dividend income from the stock-in-trade as exempt but profit from trading of such stock-in-trade is taxable under the head profit in gains of the business. In the case of Maxopp investment Ltd (supra), the Hon'ble Supreme Court has directed to apportion such interest expenses towards exempted dividend income and towards trading income. The entire interest expenditure corresponding to stock-in-trade cannot be allowed to the assessee as business expenditure.

4.3 The portion of the interest expenses related to earning of the exempted dividend income has to be disallowed. Since the issue in dispute of apportionment of interest expenses corresponding to stock-in-trade has already been restored to the file of the Assessing Officer, while deciding the disallowance under section 14A read with rule 8D of the income tax rules, this issue being connected is also restored to the file of the learned Assessing Officer for deciding a fresh in accordance with law. This ground of the appeal is also allowed for statistical purposes.

5. The ground No. 3 relates to disallowance of ₹ 6,56,24,600/- on account of provision for diminution in market value of stock-in-trade.

5.1 The Assessing Officer has observed that the assessee made a provision for diminution in market value of the stock amounting to ₹ 6,56,24,000/-which had already been added back while computing the book profit under section 115JB of the Act. According to him it is unascertained liability and not being actual expenditure incurred, and thus need to disallowed. The Ld. CIT(A) following the finding of his predecessor, allowed the ground of the assessee observing as under:

“6.3 It is noted that the issue of provision/expenditure for diminution in market value stock was adjudicated in case of the appellant for A.Y. 2003-04 and 2005-06 by the then CIT(A)-XVII and relief was allowed. Operative part of the order of the Ld. CIT(A) in A. No. 77/07-08 dated 22.09.2008 for A.Y. 2003-04 is as under:

“4.2 I have carefully considered the facts of the case, order of the AO and submissions made by the ld. AR of the appellant company. From the assessment order, it is seen that the AO has disallowed the amount of Rs.3684.92 lacs in a summary manner by holding that the same is a notional expenditure. The AO has not dispute the basic fact of the case that the investment on which diminution in the market of Rs.3684.92 lacs was claimed by the appellant was held by appellant as stock-in-trade. The AO has brazenly disregarded the guidelines of the RBI as well as the decision of various High Courts and specially the decision of Supreme Court in the case of UCO Bank(supra). The guidelines of RBI clearly states ‘Quoted current investments for each category shall be valued at cost or market value whichever is lower’.

4.2.1 Further, Supreme Court in the case of Sanjeev Woollen Mills versus Commissioner of Income Tax, [2005] 279 0434 (SC) has held that the recognized and settled practice of accounting in relation to closing stock was to value it on the cost basis or at the market value basis if the market value of the stock was less than the cost. in the case of UCO Bank (supra) also, the Apex Court has held that the consistent practice of valuing the investments by the Nationalized banks at cost or market value whichever is lower for the purpose of Income Tax Act is justified. In the case of Nedungadi Bank Limited (supra), the Hon’ble Kerala High

Court has also held that it is now settled by a series of decisions of the High Courts and the Supreme Court that the securities held by the banks Institute there stock in trade for investment and consequently the loss claimed by the banks on the valuation of their securities should be allowed as deduction in computing the taxable profits.

4.2.2 It is also a fact that in case of Punjab National Bank my predecessors have considered similar issue and on the basis of above referred judgements, especially the decision of the Apex Court in the case of UCO Bank (supra), it was held that such laws on account of diminution of value of securities cannot be disallowed by the AO. The facts in the instant case are similar to the facts of PNB's case in Apl. No.6/CIT(A) XVII/Ddel/06-07 dated 8/3/2007 as the appellant as well as PNB are dealing with the government securities in a similar manner. Therefore, following the principle of consistency and the decisions of Hon'ble High Courts and Apex Court, referred above, the claim of deduction of expenditure on account of diminution in the value of securities is correct. Accordingly, the issue is decided in favour of the appellant and the addition of Rs.36,84,92,000/- is deleted".

5.2 We have heard rival submission of the parties on the issue in dispute. The core issue is whether diminution or reduction in price of the stock-in-trade can be allowed while computing business income. In our opinion, there is no dispute that the assessee is at liberty to value its stock at cost or market value, whichever is lower as per consistent method of accounting, and such reduction if any , in value of the shares held as stock-in-trade will be allowed . But, if such a provision is made outside the trading account (only while computation of income) then same may not be allowable. In the facts of the case , it is not clear whether the provision for diminution in value of stock-in-trade has been made out of the trading account or within the trading account , therefore, we feel it appropriate to restore the issue to the file of the Assessing Officer for verifying the facts from the books of accounts and other records of the assessee and decide

the issue in dispute afresh in accordance with law. We order accordingly. The ground of the appeal is accordingly allowed for statistical purpose.

6. The appeal of the Revenue is accordingly allowed for statistical purpose.

Order pronounced in the open court on 1st May, 2020.

Sd/-
(BHAVNESH SAINI)
JUDICIAL MEMBER

Sd/-
(O.P. KANT)
ACCOUNTANT MEMBER

Dated: 01.05.2020.

RK/- (D.T.D.S)

Copy forwarded to:

1. Appellant
2. Respondent
3. CIT
4. CIT(A)
5. DR

Asst. Registrar, ITAT, New Delhi