IN THE HIGH COURT OF JUDICATURE AT BOMBAY
O. O. C. J.

INCOME TAX APPEAL NO.626 OF 2010
AND
WRIT PETITION NO.758 OF 2010

ITXA 626/10 :

Godrej & Boyce Mfg.Co.Ltd. Mumbai. ...Appellant.
Vs.
Dy. Commissioner of Income Tax,
Range 10(2), Mumbai & Anr. ...Respondents.

....

W.P. 758/10 :

Godrej & Boyce Mfg.Co.Ltd. Mumbai. ...Petitioner.
Vs.
Dy. Commissioner of Income Tax,
Range 10(2), Mumbai & Ors. ...Respondents.

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Mr.S.E.Dastur, Sr.Advocate with Mr.P.J.Pardiwala, Sr.Advocate, Mr.Nitesh Joshi i/b. Mr.Atul K. Jasani for the Appellant in ITXA 626/10, and Petitioner in W.P.758/10.
Mr.Porus F.Kaka, Sr.Advocate with Mr.Divyesh Chawla i/b. Mr.Atul K.Jasani for the Intervenor.
Mr.Darius J.Khambata, ASG with Mr.Rohan J.Cama, Mr.J.S.Saluja, Mr.Suresh Kumar and Mr.P.S.Sahadevan for the Respondents in all matters.

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CORAM : DR.D.Y.CHANDRACHUD AND
J.P.DEVADHAR, JJ.

August 12, 2010.

JUDGMENT (PER DR.D.Y.CHANDRACHUD, J.) :

A. The gist of the case :

1. Section 14A(1) of the Income Tax Act, 1961 stipulates 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." Sub-section (2) enables the Assessing Officer to 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 that may be prescribed by the Rules made under the Act if the Assessing Officer is not satisfied with the correctness of the claim of the assessee, having regard to the accounts of the assessee. By sub-section (3), the provisions of sub-section (2) are also to apply to a situation in which the assessee claims that no expenditure has been incurred in relation to income which does not form part of the total income under the Act. Section 14A was introduced by an amendment to the Finance Act of 2001 with retrospective effect from 1 April 1962. Sub-sections (2) and (3) were inserted by the Finance Act of 2006 with effect from 1 April 2007. Rule 8D of the Income Tax Rules prescribes the method for determining the expenditure incurred in relation to income which

does not form part of the total income, where the Assessing Officer is not satisfied with the claim of the assessee. Rule 8D was notified in the Official Gazette of 24 March 2008. By Section 10(33) – as it stood during Assessment Year 2002-03 - income by way of dividend referred to in Section 115-O was not to be included in computing the total income of any person for a previous year. Similarly, income received in respect of a mutual fund is not includible in the total income. (Analogous provisions have since incorporated into clauses 34 and 35 of Section 10).

2. For Assessment Year 2002-03, the assessee claimed a dividend of Rs. 34.34 crores as being exempt from the total taxable income. The assessee contended that it had not incurred any expenditure for earning the dividend income and that no disallowance was warranted. The Assessing Officer made a disallowance of Rs. 6.92 crores towards expenses attributed to the earning of the dividend income. The Commissioner (Appeals) following earlier decisions in the case of the assessee for Assessment Years 1998-99 and 1999-2000 held that no expenditure was attributable to the earning of the dividend

received and consequently, deleted the disallowance. The Tribunal by its judgment impugned in the appeal held, following its decision in the case of **Daga Capital Management Private Limited**,[1] that sub-sections (2) and (3) of Section 14A are procedural in nature and have retrospective effect. The Tribunal noted that the Assessing Officer had not examined the correctness of the claim of the assessee with reference to the accounts of the assessee, having regard to the provisions of Section 14A(2). The proceedings were remanded back to the Assessing Officer for a fresh examination on the basis of the provisions of Section 14A(2).

3. The assessee is in appeal against the decision of the Tribunal – and has raised the following substantial questions of law:

> "(A) Whether on the facts and in the circumstances of the case, the Tribunal ought to have held that as the limited issue raised by Respondent No.1 in the assessment order was as to the quantum of the exemption under Section 10(33) that was available and not to disallow any part of the expenditure claimed, hence it was not open to the Revenue to expand the scope of appeal by invoking the provisions of Section 14A of the Act to disallow the expenditure incurred;

1 117 ITD 169 (Mum)

(B) Whether on the facts and in the circumstances of the case, the Tribunal ought to have held that no disallowance could be made under Section 14A of the Act and hence erred in setting aside the issue relating to calculation of disallowance under Section 14A of the Act to Respondent No.1;

(C) Whether the Tribunal erred in directing Respondent No.1 to apply Rule 8D of the Rules for computing the amount of disallowance under Section 14A of the Act."

The assessee has, in addition, filed a Petition under Article 226 of the Constitution in order to challenge the constitutional validity of the provisions of Section 14A and of Rule 8D. Notice was issued to the Attorney General of India. Rule shall issue on the petition. In view of the importance of the question involved, Counsel for the Assessee and the Additional Solicitor General of India have agreed to the final disposal of the appeal and the Petition at this stage.

4. Broadly speaking, the submissions which have been urged on behalf of the assessee can be classified under the following heads:

-(i) Section 14A cannot be invoked in respect of dividend income from shares and mutual fund income for the reason that for

the provision to be attracted, income must be exempt from tax or must be tax free which it has been urged, is not the case;

-(ii) Even if a literal interpretation of Section 14A suggests that the provision applies because income from dividends and mutual funds is not to be included while computing the total income under Section 10(33), a literal interpretation of the provisions would give rise to unintended consequences and must, therefore, be disregarded;

-(iii) The provisions of sub-sections (2) and (3) of Section 14A and of Rule 8D are not retrospective and can have no application to Assessment Year 2002-03;

-(iv) (a) Sub-sections (2) and (3) of Section 14A are arbitrary and violative of Article 14 of the Constitution;

(b) The provisions of Rule 8D are ultra vires sub-section (2) of Section 14A and are even otherwise arbitrary and violative of Article 14 ; and

-(v) On the facts of this case, there was no factual basis for effecting the disallowance and an order of remand by the Tribunal was not warranted.

B. FACTS :

5. The assessee filed its return of income for Assessment Year 2002-03 on 29 October 2002, declaring a loss of Rs. 45.90 crores. The assessee had claimed a dividend of Rs. 34.34 crores as exempt from the total taxable income under Section 10(33). During the course of scrutiny proceedings, the assessee was called upon to explain why the net dividend income from tax free securities should not be exempted instead of the gross dividend receipts as claimed in the return. In its reply dated 25 November 2004, the assessee claimed that a major portion of its dividend amounting to Rs. 19.86 crores was received from group Companies and of the total shares, 95% consisted of Bonus Shares for which no cost had been incurred. The shares of Godrej Soaps Limited were stated to have been acquired several years earlier, the assessee being a promoter of that Company. The assessee

contended that at no stage in the past, “except in a few recent Assessment Years, has the Income Tax Department attributed any interest or expenditure towards the earning of this dividend income”. The assessee contended that it had reserves of Rs.274 crores and capital of Rs. 6.55 crores which would be more than adequate to cover the investments. The Assessing Officers were, according to the assessee, satisfied in the earlier years with its explanation and it was contended that there was consequently no allocation of interest to the earning of dividend income. During the year in question, the assessee claimed that it had not invested any amount in investments on which income was exempt under Section 10(33) and it had disposed of some of its investments at a substantial profit.

6. The Assessing Officer observed that in the common pool of funds, it was difficult to ascertain whether investments had been made out of internal accruals or from borrowed funds. The Assessing Officer was of the view that if the assessee had not made investments in these securities, it would not have been required to borrow funds to that extent and consequently, the interest burden

could have been reduced. On this basis, the Assessing Officer concluded that a part of the interest payment pertained to funds utilized for the purpose of investment in shares. The interest charged to the profit and loss account of Rs. 51.71 crores was bifurcated in the proportion between investments attributable to dividend receipts (Rs. 125.54 crores) to the total assets of the assessee (Rs. 938.11 crores). On this basis, the interest attributable to dividend receipts was computed at Rs. 6.92 crores which was disallowed.

7, In appeal, the assessee admitted that the exemption under Section 10(33) was to be allowed only on net dividend income. The assessee, however, contended that it was not permissible to notionally ascribe expenses to the earning of dividend income when in actual fact no expenses were incurred. The shares, according to the assessee, were acquired several years earlier out of generated income and no expenses were in fact incurred for the acquisition of the shares. Consequently, it was urged that if the Assessing Officer sought to apportion certain expenses towards the earning of dividend income, the onus was on

him to show that expenses had actually been incurred for earning dividend income. The Commissioner (Appeals) held that the issue had been considered by the Tribunal in the case of the assessee for Assessment Years 1998-99 and 1999-2000 where it had been held that no expenditure could be notionally attributed to the earning of dividend income. Following the decision of the Tribunal in the earlier Assessment Years, the Commissioner (Appeals) directed the Assessing Officer to consider the whole of the dividend receipts of Rs. 34.34 crores as exempt under Section 10(33).

8. The Tribunal noted that in its decision in **Daga Capital Management Private Limited**, the provisions of sub-sections (2) and (3) of Section 14A had been held to be procedural in nature and hence retrospective. The Tribunal observed that the Assessing Officer would determine the expenditure incurred in relation to income which does not form part of the total income under Sub-section (2), only where he was not satisfied with the correctness of the claim of the assessee. The Assessing Officer had, as a matter of fact, not considered Section 14A(2) since it had not been enacted on the date when the order was passed. On the view which the

Tribunal took, it directed the Assessing Officer to examine the issue afresh in the light of the specific provision contained in Section 14A(2).

C. The Challenges considered :

9. At this stage now, it would be appropriate to consider the challenges taken up on behalf of the assessee and, as we deal with them, we consider the submissions of the assessee and the arguments in defence of the Additional Solicitor General for the Union of India.

C1. <u>Whether Section 14A is attracted in the case of dividend income received from shares and income from mutual funds</u>:

-10. The submission of the assessee is that (i) Section 14A was inserted to overcome the decisions of the Supreme Court in **CIT vs. Maharashtra Sugar Mills Limited**, [2] and in **Rajastan State Warehousing Corporation vs. C.I.T**.[3] In the former case,

2 82 ITR 452
3 242 ITR 450

managing agency commission though partly relatable to earning agricultural income was permitted in its entirety as a deduction from taxable income and in the latter case, expenditure was allowed, even though relatable to exempt warehousing income as well as the taxable interest and other income; (ii) Dividend income and income from mutual funds cannot be regarded as exempt income. Tax on dividends declared, distributed or paid by the Company is imposed under Section 115-O and similar is the position of mutual funds under Section 115R. Hence, when Section 10(33) provides that such income shall not be included as income of the shareholder/Unit holder, it does not mean that this is exempt income or income which is not charged to tax; (iii) Applying Heydon's rule of interpreting statutes and considering the object of inserting Section 14A, the phrase "does not form part of the total income" should be read as equivalent to exempt income; (iv) Dividend from shares or income from units of mutual funds are not exempt income as they are charged to tax under Sections 115-O and 115R on the declaration of the dividend by a Company or, as the case may be, the distribution of income by a mutual fund. Tax is charged on such independent streams of income under Sections

115-O and 115R and is collected from the payers. This method of collection had been adopted by the Legislature in the interest of efficiency and to avoid paper work. The exemption from tax under Section 10(33) in the hands of shareholders/unit holders was enacted to obviate a double taxation of the same stream of income, once in the hands of the payer and thereafter in the hands of the recipient. Section 10(33) was enacted because tax on dividend has already been collected from the dividend paying Company; and (v) There is a specific charge independent of the Company's liability to pay tax under Section 4.

Apportionment:

-11. In certain statutory contexts, rules of apportionment were recognized by judicial decisions in India. In **Madras Co-operative Central Land Mortgage Bank Ltd. vs. Commissioner of Income Tax**[4], the Supreme Court considered the provisions of Section 14(3) of the Income Tax Act, 1922. Income of a Co-operative Society from its trading activity being exempt from tax, the income of the assessee from Government securities had to be

4 AIR 1968 SC 55.

apportioned between income earned from investment for trading purposes and for non-trading purposes. There was no statutory rule and no departmental instructions governing the apportionment of income from Government securities between business and non-business sources of income. The Supreme Court held that nonetheless a rule of apportionment would have to be applied:

> "It was never urged, and it cannot be urged, that in the absence of a specific rule for apportionment, the entire income from Government securities should be brought to tax. Any attempt to bring the entire income from Government securities would infringe Section 14(3) of the Act. A rule of apportionment consistent with commercial accounting must be evolved for determining the income from Government securities attributable to business activity of the society."

The Supreme Court held that a rule of apportionment which dismembers income in proportion to the business and non-business components of the single source from which it arises would be more consistent with the principles of commercial accounting. The proportion of income from securities which is exempt from taxation under Section 14(3) was held to be that proportion which the capital of the society used for the purpose of business bears to the

total working capital.

-12. A Division Bench of this Court presided over by Chief Justice M.C.Chagla, in the **Broach Co-operative Bank Ltd. vs. Commissioner of Income Tax**[5], upheld the application of the principle of apportionment by the Tribunal. While construing the first proviso to Section 8 of the Income Tax Act, 1922, the Division Bench held that it applied only to securities which are not tax free and, therefore, the only right of the assessee was to claim deduction with regard to interest on monies borrowed by him where he utilized those monies in investing them in securities on which he has got to pay tax, but if the assessee used money borrowed by him in investment of tax free securities, he could not claim a deduction given to him under the first proviso.

-13. In order to consider the merits of the submissions which have been urged on behalf of the assessee, it would be necessary to advert to the background underlying the enactment of Section 14A.

5 (1949) Vol.II B.L.R. 718.

14. In **C.I.T. vs. Indian Bank Limited**,[6] the assessee, carried on the business of banking and the interest received on its investment in Government securities was exempt from income tax. The assessee claimed a deduction of interest paid to depositors under Section 10(2)(iii) of the Income Tax Act, 1922. The Assessing Officer, Appellate Commissioner and the Tribunal disallowed a portion of that on the ground that it was paid on money borrowed for investment in tax free securities. The Revenue urged before the Supreme Court that there was a general principle that no expenditure can be allowed as a deduction from the profits of a business unless that part of the business to which the expenditure is attributable is capable of producing income or profits liable to tax. The Supreme Court held that there was no basis to look behind the expenditure and to determine as to whether it had the quality of producing taxable income. What was required to be ascertained under Section 10(2)(xv) was whether the expenditure had been laid out or expended wholly and exclusively for the purpose of business. The Supreme Court held that Parliament had not contemplated an enquiry on whether the

6 AIR 1965 SC 1473

expenditure had produced or will produce taxable income.

15. In a subsequent decision in **C.I.T. vs. Maharashtra Sugar Mills Limited**,[7] the Supreme Court decided whether a portion of managing agency commission paid by the assessee could be disallowed while computing income from business. The finding of the Tribunal was that the cultivation of sugarcane and the manufacture of sugar constituted one indivisible business. According to the Revenue, the business consisted of two parts, namely, cultivation of sugarcane and the manufacture of sugar. The former being agricultural, the resultant income was not assessable to tax and according to the Revenue the expenditure incurred on that activity was not deductible. The Supreme Court held that the contention proceeded on the basis that only expenditure incurred in respect of a business activity giving rise to income, profits or gains taxable under the Act was allowable as a deduction and not otherwise. The Supreme Court noted that it was not disputed that cultivation of sugarcane and manufacture of sugar constituted one indivisible business. Hence, the profits in

7 (1971) 3 SCC 543

respect of the business had to be computed after deducting the allowance under Section 10(2) including expenditure laid out or expended wholly and exclusively for the purpose of business. The allowance claimed was held to have been laid out or expended for the purpose of the business of the assessee and the fact that the income arising from a part of the business was not assessable to tax was held not to be a relevant circumstance.

16. In **Waterfall Estate Ltd. vs. C.I.T.**,[8] a finding of fact was entered by the Tribunal that the coffee curing works and estate of the assessee constituted separate and distinct activities. On this basis, the Supreme Court held that the decision in **Maharashtra Sugar** was distinguishable.

17. In a subsequent decision in **Rajasthan State Warehousing Corporation vs. C.I.T.**[9], a disallowance was effected by the Assessing Officer of such part of the expenditure which was allocable to exempt warehousing income. The Tribunal and the High Court confirmed the disallowance. Allowing the appeal, the

8 (1996) 8 SCC 509
9 2000 (109) Taxman 145

Supreme Court held as follows :

> "(i) if income of an assessee is derived from various heads of income, he is entitled to claim deduction permissible under the respective head, whether or not computation under each head results in taxable income;
>
> (ii) if income of an assessee arises under any of the heads of income but from different items, e.g. different house properties or different securities, etc., and income from one or more items alone is taxable whereas income from the other item is exempt under the Act, the entire permissible expenditure in earning the income from that head is deductible; and
>
> (iii) in computing 'profits and gains of business or profession' when an assessee is carrying on business in various ventures and some among them yield taxable income and the others do not, the question of allowability of the expenditure under section 37 of the Act will depend on : (a) fulfilment of requirements of that provision noted above; and (b) on the fact whether all the ventures carried on by him constituted one indivisible business or not; if they do, the entire expenditure will be a permissible deduction but if they do not, the principle of apportionment of the expenditure will apply because there will be no nexus between the expenditure attributable to the venture not forming integral part of the business and the expenditure sought to be deducted as the business expenditure of the assessee"

In that case, the business of the assessee being one and indivisible, the Supreme Court held that it was not open to the Revenue to disallow a portion of the expenditure.

18. The principle of law which emerged from these cases was that in the case of a composite and individual business which earned both taxable and non-taxable income, expenditure incurred towards non-taxable income could not be isolated by apportionment and a disallowance could not be made. However, apportionment of expenditure was permissible when the non-taxable income arose from a separate business or under a different head of income.

Enactment of Section 14A :

19. By the Finance Act of 2001, Parliament enacted Section 14A with retrospective effect from 1 April 1962 to amend the law by taking away the basis of the judgments of the Supreme Court in **Indian Bank, Maharashtra Sugar and Rajasthan State Warehousing Corporation**. As it was initially enacted, Section 14A postulated that for the purpose of computing the total income under the Chapter, no deduction shall be allowed in respect of expenditure incurred by an assessee in relation to income which does not form part of the total income under the Act. The

Memorandum explaining the provisions of the Finance Bill of 2001 provided the following rationale for the insertion of Section 14A:

> "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 1st April, 1962 and will accordingly, apply in relation to the assessment year 1962-1963 and subsequent assessment years."

The basic object of Section 14A is to disallow the direct and indirect expenditure incurred in relation to income which does not form part of the total income. In view of Section 10(33) inserted

by the Finance Act 1997 w.e.f. 1 April 1998, incomes by way of dividends referred to in Section 115-O are not includible in the total income. Section 14A inserted by Finance Act 2001 directs disallowance of the expenditure incurred in relation to dividends referred to in Section 115-O in certain cases.

20. Prior to the insertion of Section 14A, the Revenue had sought to disallow the expenditure incurred in relation to exempt income. However, the Supreme Court in **Maharashtra Sugar** and in **Rajasthan State Warehousing Corporation** held that where there is one indivisible business giving rise to taxable income as well as exempt income, the entire expenditure incurred in relation to that business would have to be allowed even if a part of the income earned from the business is exempt from tax. Section 14A has been enacted to overcome these judicial pronouncements.

21. The insertion of Section 14A was curative and declaratory of the intent of the Parliament. The basic principle of taxation is that only net income, namely, gross income minus

expenditure that is taxable. Expenses incurred can be allowed only to the extent that they are relatable to the earning of taxable income. However, assesses had claimed deductions in respect of income which was exempt under various provisions of the Act as a result of which the tax incentive given in respect of certain categories of income which were exempt was being utilized to reduce the tax payable on non-exempt income. This being contrary to legislative intent, Section 14A was inserted in order to restore the legal position consistent with Parliamentary intent. Declaratory or curative amendments are construed to be retrospective because they authoritatively set forth the original legislative intent. Parliament placed the matter beyond doubt by legislating upon Section 14A with retrospective effect from 1 April 1962. This was also amplified in CBDT Circular 14 of 2001.

22. Consequent upon the enactment of Section 14A, the position as it has emerged in law is that no deduction can be allowed in respect of expenditure incurred by an assessee in relation to income which does not form part of the total income under the Act. Section 14A, has the effect of broadening or

widening the earlier position. The consequence of the insertion of Section 14A has been dealt with in a judgment of the Supreme Court in **C.I.T. vs. Walfort Share and Stock Private Limited**, delivered on 6 July 2010.[10] In **Walfort**, the assessee who was a member of the Stock Exchange, purchased units of a Mutual Fund on 24 March 2000 upon which it became entitled to a dividend of Rs.1.82 crores. As a result of a payout of the dividend, the NAV of the mutual fund which was Rs.17.23 per unit on 24 March 2000, stood reduced to Rs.13.23 per unit on 27 March 2000. The assessee in the return claimed a deduction of Rs.1.82 crores as exempt from tax under Section 10(33) but also claimed a set off of the loss incurred on the sale of the units. This was disallowed by the Assessing Officer on the ground that the transaction was in the nature of dividend stripping. The disallowance was deleted by the Tribunal whose decision was confirmed by the High Court. The main issue before the Supreme Court was whether the loss on the sale of the units could be considered as expenditure in relation to earning dividend income exempt under Section 10(33) and hence disallowable under Section 14A. The Revenue claimed that the

10 Civil Appeal 4927 of 2010

differential between the purchase and the sale price of the units constituted expenditure incurred by the assessee for earning tax free income and was liable to be disallowed under Section 14A. The Supreme Court explained the reason for the insertion of Section 14A thus:

> "The insertion of Section 14A with retrospective effect is the serious attempt on the part of the Parliament not to allow deduction in respect of any expenditure incurred by the assessee in relation to income, which does not form part of the total income under the Act against the taxable income (see Circular No.14 of 2001 dated 22.11.2001). In other words, Section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. In many cases the nature of expenses incurred by the assessee may be relatable partly to the exempt income and partly to the taxable income. In the absence of Section 14A, the expenditure incurred in respect of exempt income was being claimed against taxable income. The mandate of Section 14A is clear. It desires to curb the practice to claim deduction of expenses incurred in relation to exempt income against taxable income and at the same time avail the tax incentive by way of exemption of exempt income without making any apportionment of expenses incurred in relation to exempt income. The basic reason for insertion of Section 14A is that certain incomes are not includible while computing total income as these are exempt under certain provisions of the Act. In the past, there have been cases in which deduction has been sought in respect of such incomes which in effect would mean that tax incentives to certain incomes was being used to reduce the tax payable on the non-exempt income by debiting the expenses, incurred to earn the exempt income, against taxable income. The basic

> principle of taxation is to tax the net income, i.e., gross income minus the expenditure. On the same analogy the exemption is also in respect of net income. Expenses allowed can only be in respect of earning of taxable income. This is the purport of Section 14A."

During the course of this judgment, it would be necessary to revisit the decision of the Supreme Court in **Walfort**. At this stage, however, it needs to be emphasized that the provisions of Section 14A were construed in **Walfort** to evince the Parliamentary intent not to allow deduction in respect of <u>any</u> expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act against taxable income. Section 14A is clarificatory of the position that expenses can be allowed only to the extent that they are relatable to the earning of taxable income. Only those expenses which are in respect of the earning of taxable income can be allowed. That Section 14A broadens the theory of apportionment of expenditure between taxable and non-taxable income is evident from the following observations of the Supreme Court:

> "The theory of apportionment of expenditures between taxable and non-taxable has, in principle, been now widened under Section 14A. Reading Section 14 in

> juxtaposition with Sections 15 to 59, it is clear that the words "expenditure incurred" in Section 14A refers to expenditure on rent, taxes, salaries, interest etc. in respect of which allowances are provided for (see Sections 30 to 37)."

On facts, the Supreme Court held that an expenditure is a payout which relates to disbursement. A pay back to the assessee was not an expenditure incurred within the meaning of Section 14A.

23. The judgment of the Supreme Court in **Walfort** is also significant on another aspect of the controversy in the present case. Section 14 of the Act specifies five heads of income which are chargeable to tax. Income to be taxable must fall for classification under one of those five heads, namely, (i) Salaries; (ii) Income from house property; (iii) Profits and gains of business or profession; (iv) Capital gains; and (v) Income from other sources. Sections 15 to 59 lay down the rules for computing income for the purpose of chargeability to tax under those heads. As a result of Section 14A, the permissible deductions can be allowed only with reference to income which is brought under one of those heads and

is chargeable to tax. If an income does not form part of the total income, then the related expenditure is liable to be disallowed. The test which has been enunciated in **Walfort** for attracting the provisions of Section 14A is that "there has to be a proximate cause for disallowance which is its relationship with the tax exempt income". Once the test of proximate cause, based on the relationship of the expenditure with tax exempt income is established, a disallowance would have to be effected under Section 14A.

24. The following principles would emerge from Section 14A and the decision in **Walfort**:

-(a) The mandate of Section 14A is to prevent claims for deduction of expenditure in relation to income which does not form part of the total income of the assessee;

-(b) Section 14A(1) is enacted to ensure that only expenses incurred in respect of earning taxable income are allowed;

-(c) The principle of apportionment of expenses is widened

by Section 14A to include even the apportionment of expenditure between taxable and non-taxable income of an indivisible business;

-(d) The basic principle of taxation is to tax net income. This principle applies even for the purposes of Section 14A and expenses towards non-taxable income must be excluded;

-(e) Once a proximate cause for disallowance is established – which is the relationship of the expenditure with income which does not form part of the total income – a disallowance has to be effected. All expenditure incurred in relation to income which does not form part of the total income under the provisions of the Act has to be disallowed under Section 14A. Income which does not form part of the total income is broadly adverted to as exempt income as an abbreviated appellation.

Insertion of Sub-sections (2) and (3) to Section 14A :

25. Sub-sections (2) and (3) of Section 14A were inserted by an amendment brought about by the Finance Act of 2006 with

effect from 1 April 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."
>
> (The proviso was inserted earlier by the Finance Act of 2002 with retrospective effect from 11.5.2001)

Under sub-section (2), the Assessing Officer is required to determine the amount of expenditure incurred by an assessee in relation to such income which does not form part of the total

income under the Act in accordance with such method as may be prescribed. The method, having regard to the meaning of the expression 'prescribed' in Section 2(33), must be prescribed by rules made under the Act. What merits emphasis is that the jurisdiction of the Assessing Officer to determine the expenditure incurred in relation to such income which does not form part of the total income, in accordance with the prescribed method, arises if the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of the expenditure which the assessee claims to have incurred in relation to income which does not part of the total income. Moreover, the satisfaction of the Assessing Officer has to be arrived at, having regard to the accounts of the assessee. Hence, Sub section (2) does not *ipso facto* enable the Assessing Officer to apply the method prescribed by the rules straightaway without considering whether the claim made by the assessee in respect of the expenditure incurred in relation to income which does not form part of the total income is correct. The Assessing Officer must, in the first instance, determine whether the claim of the assessee in that regard is correct and the determination must be made having regard to the

accounts of the assessee. The satisfaction of the Assessing Officer must be arrived at on an objective basis. It is only when the Assessing Officer is not satisfied with the claim of the assessee, that the legislature directs him to follow the method that may be prescribed. In a situation where the accounts of the assessee furnish an objective basis for the Assessing Officer to arrive at a satisfaction in regard to the correctness of the claim of the assessee of the expenditure which has been incurred in relation to income which does not form part of the total income, there would be no warrant for taking recourse to the method prescribed by the rules. For, it is only in the event of the Assessing Officer not being so satisfied that recourse to the prescribed method is mandated by law. Sub section (3) of Section 14A provides for the application of sub section (2) also to a situation where the assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under the Act. Under the proviso, it has been stipulated that nothing in the section will empower the Assessing Officer, for an Assessment Year beginning on or before 1 April 2001 either to reassess under Section 147 or pass an order enhancing the assessment or reducing the refund

already made or otherwise increasing the liability of the assessee under Section 154.

26. 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 CBDT dated 28 December 2006.[11] 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 tax payers 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.

11 Circular 14 of 2006

Section 115-O :

27. The submission which has been urged on behalf of the assessee is that Section 14A has no application either to dividend income or to income from mutual funds. The submission proceeds on the basis that the words "in relation to income which does not form part of the total income under this Act" can have no application to dividend income from shares or to income from mutual funds for the reason that such income is not exempt from income tax, but is subject to tax under Section 115-O and Section 115R.

28. Now, Sub-section (1) of Section 115-O prior to its substitution by the Finance Act of 2003 with effect from 1 April 2003, provided as follows :

> "(1) Notwithstanding anything contained in any other provision of this Act and subject to the provisions of this section, in addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June, 1997 but on or before the 31st day of March, 2002, whether out of current or accumulated profits shall be

> charged to additional income tax (hereinafter referred to as tax on distributed profits) at the rate of ten per cent."

Sub-section (2) of Section 115-O stipulates that the tax on distributed profits under sub-section (1) shall be payable by the company notwithstanding that no income tax is payable by a domestic company on its total income computed in accordance with the provisions of the Act. Sub-sections (4) and (5) of Section 115-O provide as follows :-

> "(4) The tax on distributed profits so paid by the company shall be treated as the final payment of tax in respect of the amount declared, distributed or paid as dividends and no further credit therefor shall be claimed by the company or by any other person in respect of the amount of tax so paid.
>
> (5) No deduction under any other provision of this Act shall be allowed to the company or a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon."

Sub-section (1) of Section 115-O begins with a non obstante provision and stipulates that any amount declared, distributed or paid by a company by way of dividends shall be charged to additional income tax: 'Additional' because this is in addition to

income tax chargeable in respect of the total income of the domestic company. The total income of a domestic company is chargeable to income tax under the Act. In addition, any amount declared, distributed or paid by such company by way of dividends is subjected to additional income tax at the stipulated rate. The charge under sub section (1) of Section 115-O is on a component of the profits of the domestic company representing an amount declared, distributed or paid by way of dividend.

29. The plain meaning of Section 14A is that no deduction can be allowed in respect of expenditure incurred by an assessee in relation to income which does not form part of the total income under the Act. Section 10 provides for incomes which shall not be included in computing the total income of a previous year of any person. Prior to the amendment brought about by the Finance Act of 2003 with effect from 1 April 2003, income by way of dividends referred to in Section 115-O and income received in respect of the units of a mutual fund did not form part of the total income by virtue of the provisions of clause 33 of Section 10. (Clause 33 of Section 10 was omitted by the Finance Act of 2003. Clauses 34

and 35 which were inserted by the same Finance Act, now provide that income by way of dividends referred to in Section 115-O and income received in respect of the units of a mutual fund specified in clause 23(b) shall not be included in computing the total income of any person for the previous year). Plainly dividend income and income from mutual funds are incomes which by virtue of the provisions of Section 10, do not form part of the total income under the Act. Expenditure incurred in relation to the earning of such income has to be disallowed under Section 14A.

30. The submission which has been urged on behalf of the assessee is that the expression "income which does not form part of the total income" under the Act should be interpreted to mean income which is exempt from tax, On this hypothesis, it has been urged that Section 14A will not apply to dividend income because the Revenue has already received its share of tax.

31. The submission cannot be accepted. The expression "income which does not form part of the total income" under the Act must receive its plain and grammatical construction. Such

income is income which is not includible in computing the total income of the assessee under the provisions of the Act for a previous year. Now it is trite law that under the Act, "it is income that is taxed but it is not taxed in vacuo. It is taxed in the hands of a person."[12] Section 2(45) defines the expression "total income" to mean the total amount of income referred to in Section 5, computed in the manner laid down in the Act. Section 4 charges the total income "of the previous year" of every person to income tax. Section 5 makes a reference to the scope of the total income of any previous year of a person who is the recipient. This is defined to include all income, from whatsoever sources derived, which is received or deemed to be received or which accrues or is deemed to have accrued in India or which accrues or arises outside India during the previous year. Section 10 defines those categories of income which shall not be included in computing the total income of the previous year of any person. Income tax is a tax on income in the hands of the assessee. Hence, when Section 14A disallows expenditure incurred by the assessee in relation to income which does not form part of the total income, it would include categories

12 CIT vs. Indian Bank Limited, AIR 1965 SC 1473 at paragraph19 page 1476.

of income such as dividend from shares and income from mutual fund which under Section 10 are not to be included in the total income. Since dividend income and income from mutual funds are not included in the total income of the assessee, no deduction of expenditure is permissible under Section 14A(1). Sub-section (5) of Section 115-O stipulates that no deduction under any other provisions of the Act shall be allowed to the Company or to a shareholder in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon.

32. The tax which is paid by the Company on profits declared, distributed or paid by way of dividend is not a tax which is paid on behalf of the shareholder. The company is liable to pay income tax in respect of its total income. In addition to the income tax chargeable in respect of its total income, a domestic Company is charged with the payment of additional income tax, called a tax on distributed profits on any amount declared, distributed or paid by the Company by way of dividend. The charge under sub-section (1) of Section 115-O is on the profits of the Company; more specifically on that part of the profits which is declared, distributed

or paid by way of dividend. The charge under sub-section (1) of Section 115-O is not on income by way of dividend in the hands of the shareholder.

The additional income-tax payable on profits of a domestic company under Section 115-O is not a tax on dividend

33. Section 115-O provides that a domestic company which declares, distributes or pays dividend out of current or accumulated profits, shall, apart from paying tax on its total income, pay additional income-tax on the amount of profits declared, distributed or paid as dividend or after 1 April 2003.

34. To illustrate, if Rs.1,000/- is the total income of a domestic company and out of the total income of Rs.1,000/-, Rs. 300/- is declared, distributed or paid as dividend, then that domestic company is liable to pay income tax on the total income of Rs.1,000/- at the rate specified under the relevant Finance Act and is further liable to pay additional income-tax at the rate prescribed under Section 115-O on the amount of profits declared,

distributed or paid as dividend.

35. Section 115-O has been enacted with a view to exempt dividend income. Prior to the insertion of Section 115-O, domestic companies were liable to pay tax on the total income (including profits distributed as dividends) and shareholders were liable to pay tax on dividend income received. Domestic companies distributing profits as dividends were liable to deduct tax at source and shareholders receiving the dividend were entitled to take credit of such tax deducted at source. As this method was found to be cumbersome, Parliament chose to exempt dividend income in the hands of the shareholder and chose to levy additional income-tax on the amount of profits declared, distributed or paid as dividend by the domestic companies. Thus, by inserting Section 115-O, additional income-tax is levied on the amount of profits declared, distributed or paid as dividend and by inserting Section 10(33) it is made clear that the dividends referred to in Section 115-O would be exempt from tax.

36. In **Purushottamdas Thakurdas vs. C.I.T.**[13] the Supreme Court construed the provisions of Section 16(2) and Section 49B of the Indian Income Tax Act, 1922. Sub-section (2) of Section 16 provided that any dividend shall be deemed to be income of the year in which it is paid regardless of the question as to when the profits out of which the dividend is paid were earned. By a deeming fiction introduced by Section 49B, when a dividend was paid to a shareholder by a Company which was assessed to tax, the income tax in respect of such dividend was deemed to have been paid by the shareholder himself. The Supreme Court observed that the position as a matter of general law was as follows:

> "In general law, the Company is chargeable to tax on its profits as a distinct taxable entity and it paid tax in discharge of its own liabilities and not on behalf of or as an agent for its shareholders".[14]

This principle of general law was overridden by the deeming fiction that was created by Section 49B in the Act of 1922.

13 (1963) 48 ITR 206.
14 At pages 213 & 214 of Purushottamdas (supra)

37. Significantly, in the Income Tax Act, 1961, Parliament has not made such a deeming provision as was enacted in Section 49B of the act of 1922. On the contrary, sub-section (4) of Section 115-O has the effect of providing that the shareholder cannot claim any credit for the amount paid by the Company under Section 115-O(1). There is, therefore, merit in the submission of the Additional Solicitor General that dividend received by the shareholder is not tax paid. Similarly, as noted earlier, under sub-section (5), a shareholder is not entitled to claim any deduction in respect of the amount which has been charged to tax under sub-section (1) of Section 115-O or the tax thereon. Hence, viewed from the perspective of Section 115-O as well as Section 14A, it is evident that the tax on distributed profits is a charge on the Company. The Company is chargeable to tax on its profits as a distinct taxable entity. It does not do so on behalf of the shareholder. The Company does not act as an agent of the shareholder in paying the tax under Section 115-O. In the hands of the recipient shareholder dividend does not form part of the total income. On the contrary, Section 10(33) clearly evinces parliamentary intent that incomes from dividend (and from mutual

funds) are not includible in the total income.

38. Counsel appearing on behalf of the Assessee sought to place reliance on a circular issued by the CBDT on 18 February 1998, explaining the provisions of the Finance Act of 1997, which introduced the provisions of Section 115-O. The circular notes that according to the existing provisions of the Act, corporate dividends were taxed in the hands of shareholders under the head of income from other sources. Companies while paying dividend deducted tax at source at the rate in force and issued certificates of tax deduction to their shareholders. The shareholders, in turn, showed dividend income in their returns of income and claimed credit for tax deducted on the basis of these certificates. The existing method was found to involve "a lot of paper work" and there were demands that tax on dividend should be abolished as it would tantamount to double taxation, once in the hands of the Company and again in the hands of the shareholders. The Circular states that the Finance Act of 1997, therefore, introduced a new system of collecting tax on profits distributed by the Company by way of dividend, which was to be in addition to the income tax chargeable

in respect of the total income of the Company.

39. The circular issued by the CBDT as a matter of fact clearly establishes that prior to the introduction of Section 115-O of the Finance Act of 1997, corporate dividends were taxed in the hands of shareholders as income from other sources. This provision was abolished by the introduction of Section 115-O. Under sub-section (1) of Section 115-O, an additional income tax was imposed on profits distributed by a Company by way of dividend and a new clause, clause 33 was inserted in Section 10 to exempt dividend income in the hands of the shareholder.

40. We have also been fortified in the conclusion which we have drawn, by the judgment of the Supreme Court in **Walfort** (supra). The Supreme Court has in the following observation expressly held that since dividend income does not form part of the total income, the expenditure that is incurred in the earning of such income cannot be allowed even though it is of a nature specified in Sections 15 to 59:

"If an income like dividend income is not a part of the

> total income, the expenditure/deduction though of the nature specified in Sections 15 to 59 but related to the income not forming part of the total income could not be allowed against other income includible in the total income for the purpose of chargeability to tax."

Having observed thus, the Supreme Court held that the theory apportioning expenditure between taxable and non-taxable income has now, in principle, been widened under Section 14A. Hence, for the reasons that we have indicated earlier, we hold that income from dividend on shares is, in the hands of the recipient shareholder, income which does not form part of the total income. Hence, Section 14A would apply and the expenditure incurred in earning such income would have to be disallowed. Income from mutual fund stands on the same footing.

-41. Another submission which has been urged on behalf of the assessees by Mr.Kaka, intervening Counsel is that Section 10 deals with three categories : (i) The first category is where the emphasis is on income which is exempt in the hands of any person. This category deals with the character of income such as agricultural income and not of the recipient of the income; (ii) The

second category exemplified by sub-sections (2) and (2A) of Section 10 (where the recipient is a member of HUF or a partner) is where the same income is not to be charged to tax twice in the hands of two persons; (iii) The third category is where the character of the recipient is important and not the character of the income, e.g., a local authority. The submission is that Section 10(33) is not an exemption provision, but has been made to prevent the State from taxing the same income twice over. The object of Section 10(33), it was urged, is to prevent double taxation and Section 14A cannot apply to such a situation. In other words, it has been urged that it was only to disallow expenditure covered by the first category of Section 10 - where the income is fully exempt from taxation in the hands of any person – that Section 14A has been enacted.

-42. We do not find any warrant for an artificial reading down of the provisions of Section 14A in the manner that is sought to be done. Section 14A plainly stipulates that 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. Dividend income does not form part of the total income under the Act by virtue of the provisions of Section 10(33). Consequently, it is impossible to accede to the submission that Section 14A should be confined only to those categories of income, such as agricultural income, where the income is exempt in the hands of any person. The judgment of the Privy Council in **C.I.T. vs. Rameshwar Singh**,[15] is of no relevance to the issue involved in this case. While construing the provisions of the Income Tax Act, 1922, the Privy Council observed that agricultural income is excluded altogether from the scope of the Act whatsoever or by whomsoever it may be received. This would have no bearing on the construction to be placed on the provisions of Section 14A.

A Summation of our conclusions on the interpretation of the provisions:

-43. In order to conclude the discussion on this aspect of the case, we would proceed to recapitulate our conclusions.

-(i) Section 14A was enacted by Parliament in order to overcome the judgments of the Supreme Court in the case of **Indian Bank, Maharashtra Sugar** and **Rajasthan Warehousing**

15(1935) 3 ITR 305

Corporation in which it was held that in the case of a composite and indivisible business, which results in earning of taxable and non-taxable income, it is impermissible to apportion the expenditure between that which was laid out for the earning of taxable as opposed to non-taxable income;

-(ii) The effect of Section 14A is to widen the theory of the apportionment of expenditure. Prior to the enactment of Section 14A where the business of an assessee was not a composite and indivisible business and the assessee earned both taxable and non-taxable income, the expenditure incurred on earning non-taxable income could not be allowed as a deduction as against the taxable income. As a result of the enactment of Section 14A, no expenditure can be allowed as a deduction in relation to income which does not form part of the total income under the Act. Hence, even in the case of a composite and indivisible business, which results in the earning of taxable and non-taxable income, it would be necessary to apportion the expenditure incurred by the assessee. Only that part of the expenditure which is incurred in relation to income which forms part of the total income can be

allowed. The expenditure incurred in relation to income which does not form part of the total income has to be disallowed;

-(iii) From this it would follow that Section 14A has implicit within it a notion of apportionment. The principle of apportionment which prior to the amendment of Section14A would not have applied to expenditure incurred in a composite and indivisible business which results in taxable and non-taxable income, must after the enactment of the provisions apply even to such a situation;

-(iv) The expression "expenditure incurred" in Section 14A refers to expenditure on rent, taxes, salaries, interest etc. in respect of which allowances are provided for;

-(v) Sub-sections (2) and (3) of Section 14A are intended to enforce and implement the provisions of Sub-section (1). The object of sub-section (2) is to provide a uniformity of method where the Assessing Officer is, on the basis of the accounts of the assessee, 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 the Act;

-(vi) Even in the absence of sub-section (2) of Section 14A, the Assessing Officer would have to apportion the expenditure and to disallow the expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. The Assessing Officer would have to follow a reasonable method of apportioning the expenditure consistent with what the circumstances of the case would warrant and having regard to all the relevant facts and circumstances;

-(vii) Consequent upon the insertion of sub-section (2), the disputes which had arisen between tax payers and the Revenue on the method of determining the expenditure to be disallowed, have been given a quietus by adopting a uniform method of determination;

-(viii) Sub-section (2) of Section 14A does not enable the Assessing Officer to apply the method prescribed by Rule 8D

without determining in the first instance the correctness of the claim of the assessee, having regard to the accounts of the assessee. Sub-section (2) of Section 14A mandates that it is only when having regard to the accounts of the assessee, the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of expenditure incurred in relation to income which does not form part of the total income under the Act, that he can proceed to make a determination under the Rules;

-(ix) The satisfaction envisaged by Sub-section (2) of Section 14A is an objective satisfaction that has to be arrived at by the Assessing Officer having regard to the accounts of the assessee. The safeguard introduced by Sub-section (2) of Section 14A for a fair and reasonable exercise of power by the Assessing Officer, conditioned as it is by the requirement of an objective satisfaction, must, therefore, be scrupulously observed. An objective satisfaction contemplates a notice to the assessee, an opportunity to the assessee to place on record all the relevant facts including his accounts and recording of reasons by the Assessing Officer in the event that he comes to the conclusion that he is not satisfied

with the claim of the assessee;

-(x) The effect of Section 115-O is that in addition to the income tax chargeable on the total income of a domestic Company, additional income tax is charged on profits declared, distributed or paid. This tax which is referred to as a tax on distributed profits is what it means, namely, a tax on the profits of the Company. This is not a tax on dividend income. Under Section 115-O, the charge is on a component of the profits of the Company; that component representing profits declared, distributed or paid. The tax under Section 115-O is not a tax which is paid by the Company on behalf of the shareholder, nor does the Company act as an agent of the shareholder in paying the tax. This legal position is fortified by the circumstance that the shareholder is not entitled to any deduction in respect of the amount which has been charged to tax under sub-section (1) or the tax thereon;

-(xi) Additional income-tax liability on the profits declared, distributed or paid as dividend by a domestic company, cannot be considered as tax on dividend, because,

(a) Provisions contained in Chapter XII-D are special provisions relating to tax on the distributed profits of domestic companies. Even Section 115-O in Chapter XII-D clearly states that the additional income-tax liability thereunder is on the amount of profits declared, distributed or paid by a domestic company as dividend. Thus, the additional income tax under Section 115-O is a tax on profits and not a tax on dividend.

(b) Distribution of profits as dividend being appropriation of profits, the company distributing profits as dividend is liable to pay tax on the total income inclusive of the amount of profits distributed as dividend. By inserting Section 115-O, the legislature has imposed additional income-tax on the amount of profits distributed as dividend. Thus, tax as well as additional income-tax are taxes levied on the profits of a domestic company. From the fact that the additional income-tax is

levied only on profits declared, distributed, or paid as dividend, it cannot be said that the additional income-tax is not a tax on the profits of the domestic company but a tax on dividend.

(c)) Where profits of a Company are distributed as dividend, those profits are taxed in the hands of the Company and dividends are taxed in the hands of the shareholders because the character of the income in the hands of a Company and in the hands of a shareholder is totally different. Profits in the hands of a company would be business income, whereas, the said amounts when distributed as dividend, would constitute dividend income in the hands of the shareholders. In such a case, the liability on the Company is on profits of business income, where as the tax liability on the shareholder would be on the dividend income. The legislature has chosen to exempt tax on dividend income and has chosen to impose additional tax on profits distributed as dividend. Therefore, the tax as well as additional tax are

taxes levied on a domestic company on its profits and it cannot be said that the regular / normal tax is levied on profits and the additional tax is levied on the dividend. When Section 115-O specifically states that the additional tax is on the profits distributed as dividend, there is no reason to hold that the additional income-tax is a tax on dividend.

(d) Income-tax is charged on the income earned by an assessee. When profits are distributed as dividend, there is no income earned by a domestic company and consequently, there is no question of taxing the amount distributed as dividend. However, the legislature has chosen to impose additional tax in addition to the regular tax, payable on the profits of a domestic Company. Thus, the regular tax as well as the additional tax are taxes on the profits of the domestic companies.

(e) Incomes enumerated in Section 10 are not includible in the total income, because the legislature

exempts such income from tax. Dividends referred to in Section 115-O are covered under Section 10(33) and hence exempt from tax. As noted earlier, the additional tax under Section 115-O is a tax on the profits distributed as dividend and not a tax on dividend. In the absence of Section 10(33), tax would have been payable on the dividends referred in Section 115-O. Therefore, it is clearly evident from Section 10(33) that dividends referred to in Section 115-O are exempt from tax.

(f) It is contended that dividends taxed in the hands of a domestic company under Section 115-O if held taxable again in the hands of a shareholder, would amount to double taxation. There is no merit in this contention because, additional tax is a tax on the profits of the Company which is distributed as dividend, whereas, tax in the hands of a shareholder is a tax on dividend income.

(g) This is also supported by Circular No.763

dated 18 February 1998 issued to explain the provisions of Section 115-O and Section 10(33) inserted by Finance Act 1997. The Circular, clearly and unequivocally states that Section 10(33) and Section 115-O are intended to exempt dividend income and levy a new tax on distributed profits on domestic companies. Thus, what is collected under Section 115-O is the additional tax on profits distributed as dividend and not a tax on dividends, because dividends received are exempt under Section 10(33).

-(xii) The general principle of law is that a Company is chargeable to tax on its profits as distinct taxable entity and has to pay tax in discharge of its own liability and not on behalf of or as an agent of its shareholders. This position of the general law is recognized and incorporated in Section 115-O and is not overridden by the statutory provision;

-(xiii) Income from dividend and similarly, income from mutual funds do not form part of the total income under Section 10(33).

The expenditure incurred in relation to earning such income cannot be allowed under Section 14A;

-(xiv) In order to determine the quantum of the disallowance, there must be a proximate relationship between the expenditure and the income which does not form part of the total income. Once such a proximate relationship exists, the disallowance has to be effected. All expenditure incurred in the earning of income which does not form part of the total income has to be disallowed subject to compliance with the test adopted by the Supreme Court in **Walfort** and it would not be permissible to restrict the provisions of Section 14A by an artificial method of interpretation.

-C.2 A plain and grammatical construction does not lead to absurdity:

44. On behalf of the assessee, it is sought to be urged that the application of the literal meaning of Section 14A would result in absurd consequences. In dealing with the submission, this Court must have due regard to the principle of law which is enunciated by the Supreme Court in **CIT vs. J.H.Gotla**,[16] that "Where the plain and literal interpretation of a statutory provision produces a

16 146 ITR 323

manifestly unjust result which could never have been intended by the Legislature, the court might modify the language used by the Legislature so as to achieve the intention of the Legislature and produce a rational construction." As the Supreme Court observed "equity and taxation are often strangers" yet "attempts should be made that these do not remain always so and if a construction results in equity rather than injustice, then such construction should be preferred to the literal construction". The same principle was adopted by the Supreme Court in an earlier decision in **K.P.Verghese vs. Income Tax officer.**[17] On similar lines is the decision of the Karnataka High Court in **CIT vs. H.S.Shivarudrappa.**[18]

45. The Court will not lightly reject the plain and grammatical construction of a statute. The subject must be within the letter of the law and the Court will not abandon the words used by the legislature in preference to a diffuse if even ephemeral object of deciphering purpose. Legislative purpose in fiscal enactments must lie within the folds of the words used. Before the

17 (1981) 131 ITR 597
18 200 ITR 1

Court rejects the plain and grammatical construction of a statute, it must be satisfied that such a construction would lead to a result unintended by the Legislature or result in an absurdity. For one thing, individual cases of hardship, set up on the basis of hypothetical examples tendered at the Bar do not establish absurdity of the law. Moreover, it has been submitted by the Additional Solicitor General that the example tendered before the Court proceeds on several assumptions these being : (i) An assumption that had there been no tax under Section 115-O, the Board of Directors of a Company would have recommended a higher dividend (higher by the extent of the tax) for distribution to the shareholders; (ii) The assumption that in effect, it is the shareholder who bears the tax under Section 115-O(1) since the shareholder has forgone the assumed higher dividend; (iii) An assumption that the payment of tax under Section 115-O(1) is on behalf of the shareholder. On these assumptions, the conclusion is sought to be drawn by the assessee that the shareholder will suffer twice, namely, by the assumed payment of tax on his behalf under Section 115-O(1) and by the disallowance on expenditure claimed under Section 14A. We are in agreement with the submission

which has been urged on behalf of the Union Government that the contention that the literal interpretation of Section 14A would lead to an absurd consequence is erroneous. As the Supreme Court observed in **Walfort**, Section 14A represents a serious attempt on the part of Parliament to ensure that the tax incentive to certain incomes should not be used to reduce the tax payable on non-taxable income by debiting expenses incurred to earn non-taxable income against the taxable income. In other words, what Section 14A effectuates is that a shareholder should not get the benefit both of an exemption under Section 10(33) and also a deduction in respect of the expenditure laid out towards earning tax free income. If the dividend income had not been exempt under Section 10(33), the Revenue would have taxed such dividend income and the assessee would have been entitled to a deduction in respect of its expenditure in relation to that income. Dividend income does not form part of the total income under Section 10(33). Section 14A ensures that the shareholder whose income from dividend is not included in the total income of a previous year shall not claim a deduction in respect of the expenditure incurred in relation to earning such income. Section 14A is founded on a

valid rationale that the basic principle of taxation is to tax net income that is to say, gross income minus the expenditure. On that analogy as the Supreme Court observed in **Walfort**, the exemption is also in respect of net income and expenses allowed can only be in relation to the earning of taxable income. We do not, therefore, accept the submission of the assessee that an absurdity would result on the application of the literal interpretation of Section 14A.

-C.3 Constitutional validity of Sub-sections (2) and (3) of Section 14A and of Rule 8D:

46. Rule 8D provides as follows :

> "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:-

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

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."

Section 14A(2) and (3):

47. On behalf of the assessee, it has been submitted that (i) The very idea that there can be a uniform rule for determining the expenditure relating to the earning of tax free income is arbitrary and violative of Article 14. Every industry, it has been urged, has its own peculiar background and one cannot equate a manufacturing industry with a service industry or an entity dealing in investment or in shares. Every asset has its peculiar situation. Sub-section (2) of Section 14A by providing for a uniform method of applicability, is alleged to treat unequals alike and is, therefore, said to be violative of Article 14; (ii) Section 14A(2) confers a power and if it is interpreted as having been conferred retrospectively, it would be *ultra vires* as one can never conceive of a power to do something being conferred with retrospective effect.

Rule 8D:

48. The submission on behalf of the assessee in the challenge to Rule 8D is as follows:

-(i) Under Rule 8D(2)(i) direct expenditure relating to

exempt income is taken into account and under Rule 8D(2)(ii)A from the total interest expenditure, direct interest expenditure for earning tax free income is to be excluded. The 'A' portion of the balance sheet is to be disallowed without exclusion of interest expenditure directly relatable to earning taxable income; (ii) Under Rule 8D(2)(ii)B that is in the numerator of the ratio, the average of the value of investments is taken without reducing it by (a) Investments directly relatable to own funds as there can be no question of apportioning any part of the interest to investment which has given out of own funds and (b) Investments which are directly relatable to borrowed funds as otherwise apart from the direct interest disallowed under Rule 8D(2)(i), there would be a double disallowance of interest by way of a higher allocation of indirect interest expending under Rule 8D(2)(ii); and (iii) The determination of disallowance under Rule 8D(2)(ii)C adopting half percent of average value taken has nothing to do with the amount of the actual expenditure. In fact, the amount arrived at under the Rule can even exceed the total expenditure incurred by an assessee; (iv) The form prescribed in Rule 8D goes beyond Sub-section (2) of Section 14A and at the least does not prescribe an

accepted or a well settled method for determining expenditure.

49. On the other hand, it has been submitted on behalf of the Union of India that (i) Judicial review of the measure or manner in which a tax is computed is limited and it is only if there is perversity or capriciousness in the method adopted by the Legislature, that it would violate Article 14; (ii) The provisions of Rule 8D are in conformity with the principle contained in Section 14A(1) and only provide for a measure and mechanism to compute the portion of expenditure attributable to exempt income; (iii) Rule 8D provides a rational, fair and reasonable method for computing the quantum of expenditure attributable to tax exempt income. The provision presents a reasonable solution to assess a complex accounting and tax problem and the underlying rationale has been explained in the affidavit in reply; (iv) The fact that Rule 8D adopts a uniform method as a means of computation does not make it arbitrary or unreasonable: (a) The method will be adopted only if the Assessing Officer is not satisfied of the correctness of the claim of the assessee, having regard to the accounts of the assessee; (b) The adoption of standard rates or percentages to compute

figures of income or expenditure are not abhorrent to tax legislation; (v) An estimate can be made so long as it is not arbitrary and has a nexus with the facts discovered. Even if the Court believes that it is not a best estimate or the most appropriate method, it cannot be struck down since in the realm of constitutional validity, the Court is not concerned with mathematical or scientific exactitude of the method; (vi) Rule 8D only provides a machinery or method to measure and attribute expenditure that is relatable to tax exempt income. On the contrary, if expenditure utilized towards earning tax exempt income was a permissible deduction, the assessee would have the benefit not only of the exemption from tax of the income earned but also the benefit of a reduction of taxable income by the amount of expenditure incurred not towards taxable income, but towards income which is already exempt from tax; (vii) Rule 8D(2)(ii) applies only to a grey area where it is not possible to determine the borrowing on which interest was paid. Where the assessee has failed to correctly apportion the expenditure, the Assessing Officer has to adopt the prescribed formula and the amount of interest attributable to exempt income also has to be computed by a

formula. Since funds are fungible, it would be difficult to allocate the actual quantum of borrowed funds that have been used for making tax free investments. It is only the interest on borrowed funds that will be apportioned – the amount of expenditure by way of interest that will be taken (as 'A') will exclude any expenditure by way of interest which is directly attributable to any particular income or receipt (e.g. any aspect of the assessee's business such as plant/machinery etc.); (viii) As regards Rule 8D(2)(iii) since investments and the income that they realize will not usually require direct administrative or management expenses, and since these are usually accounted for in common with all the other businesses of the assessee, logic requires that some mechanism or formula be adopted for attributing part of the administrative/managerial expenses to the tax exempt investment income. It is common knowledge that under the Portfolio Management Scheme portfolio managers charge about 2 to 2.5% of the portfolio value as a fee. The profit element of such fee usually does not exceed 1% of the portfolio value. As set out in detail in the affidavit in reply adopting 0.50% of the average of the value of investments (income from which is tax exempt) is not

unreasonable and results in identification of expenditure which has a direct and immediate connection with the tax exempt income; (ix) If a pro-rata method was applied in the alternative to the aforesaid method provided in Rule 8D(2)(iii) the amount of disallowance would be immense, as set out in the Chart tendered to the Court by the Revenue. In the case of the Appellant for the assessment year under consideration, on an expenditure of Rs. 189.77 crores (excluding direct expenditure and expenditure on power, fuel etc.), the disallowance under the pro-rata method as followed in Rule 8D(2)(ii) would be Rs.82 crores. However, under the 0.5% measure provided by Rule 8D(2)(iii) the disallowance is Rs.1.57 crores. Hence, the present measure is in fact, more favourable to the assessee and cannot under any circumstances be said to be unconstitutional; (x) Hence, the intention of Section 14A is clearly to disallow all expenses relating to the non-taxable income, and to curb the practice of claiming allowances for expenditures on exempt income. All that is required is to show that there is a 'proximate cause' between the expenditure incurred and the exempt income. A 'proximate cause' connotes a relationship between the expense and the exempt income (**Walfort**

supra). So understood, even indirect expenses may have a proximate cause to the exempt income, and the same must hence be disallowed. For example, if the staff employed in an office partake in both manufacturing and dividend business, that proportion of the staff (indirect) expenses incurred in relation to the dividend business will be disallowed. However, if the assessee does not maintain separate accounts, it would be necessary for the Assessing Officer to determine the proportion of expenditure incurred in relation to the dividend business (i.e. earning exempt income). It is for exactly such situations that a machinery/method for computing the proportion of expenditure incurred in relation to the dividend business has been provided by way of Section 14A(2)/(3) and Rule 8D.

The Parameters of judicial review

50. There is a presumption of constitutionality which is ingrained in our constitutional jurisprudence. This presumption is founded on the principle of democratic governance which recognizes that while the judiciary is invested with the power of judicial review, the Legislature which is responsible to the people is

responsive to the needs and concerns of Society. In matters of economic regulation, the Legislature and its delegate must have the power to frame new policies and adjust existing ones in accordance with the felt needs of the time. While dealing with challenges to fiscal legislation, these principles must apply a *fortiorari*. The Court recognizes the existence of a healthy discretion in the Legislature in determining the subject of tax, the grant of exemptions and the creation of a machinery that would effectively enforce charging provisions.

51. In **Khandige Sham Bhat v. Agricultural Income Tax Officer**[19], a Constitution Bench of the Supreme Court observed thus :

> "Courts, in view of the inherent complexity of fiscal adjustment of diverse elements, permit a larger discretion to the Legislature in the matter of classification, so long it adheres to the fundamental principles underlying the said doctrine. The power of the Legislature to classify is of "wide range and flexibility" so that it can adjust its system of taxation in all proper and reasonable ways."

52. Again, the Supreme Court emphasized that though the

19 AIR 1963 SC 591

method suggested may be better than the method actually adopted by the legislature, the hardship in individual cases cannot in any event be avoided. Unless the method which has been adopted is capricious, fanciful, arbitrary or clearly unjust, the Court would be loathe to strike down the law :

> "It is true taxation law cannot claim immunity from the equality clause of the Constitution. The taxation statute shall not also be arbitrary and oppressive, but at the same time the Court cannot, for obvious reasons, meticulously scrutinize the impact of its burden on different persons or interests. Where there is more than one method of assessing tax and the Legislature selects one out of them, the Court will not be justified to strike down the law on the ground that the Legislature should have adopted another method which, in the opinion of the Court, is more reasonable, unless it is convinced that the method adopted is capricious, fanciful, arbitrary or clearly unjust."

Advantages or disadvantages to individual assesses are "accidental and inevitable and are inherent in every taxing statute as it has to draw a line somewhere and some cases necessarily fall on the other side of the line."[20]

53. In **Ganga Sugar Corporation Ltd. v. State of Utter Pradesh**[21] the Supreme Court recorded a caution which must be

20 at para 10 page 597.
21 (1980) 1 SCC 223.

observed by the Court in dealing with challenges to the constitutional validity of taxing statues :

> "Practical considerations of the Administration, traditional practices in the trade, other economic pros and cons enter the verdict but, after a judicial generosity is extended to the legislative wisdom, if there is writ on the statute perversity, ' madness' in the method or gross disparity, judicial credulity may snap and the measure may meet with its funeral."

54. Classification for taxation and the application of Article 14 in that context has to be viewed liberally and not meticulously. Classification, as held by the Supreme Court, is primarily for the legislature and becomes a judicial issue only when " the legislation bears on its bosom obvious condemnation by way of caprice or irrationality"[22]. In **State of Uttar Pradesh V. Kamla Palace**[23], a Bench of three Learned Judges of the Supreme Court observed, following the decision in **R.K. Garg v. Union of India**[24] that laws relating to the field of taxation "enjoy a greater latitude than laws touching civil rights" and such legislation ought not to be struck down "merely on account of crudities and inequities inasmuch as such legislations are designed to take care of complex situations

22 at para 45 page 238.
23 (2000) 1 SCC 557.
24 (1981) 4 SCC 675.

and complex problems which do not admit of solutions through any doctrinaire approach or straitjacket formulae". Mr. Justice R.C.Lahoti (as the Learned Chief Justice then was) speaking for the Bench observed as follows :

> "The legislature gaining wisdom from historical facts, existing situations, matters of common knowledge and practical problems and guided by considerations of policy must be given a free hand to devise classes – whom to tax or not to tax, whom to exempt or not to exempt and whom to give incentives and lay down the rates of taxation, benefits or concessions. In the field of taxation if the test of Article 14 is satisfied by generality of provisions the courts would not substitute judicial wisdom for legislative wisdom."

55. In **Gujarat Ambuja Cements Limited v. Union of India**[25] Mrs. Justice Ruma Pal, speaking for a Bench of two Learned Judges followed the observations of the Constitution Bench in **Ganga Sugar** (supra) and observed thus :

> "Because of the inherent complexity of fiscal adjustments of diverse elements in the field of tax, the legislature is permitted a large discretion in the matter of classification to determine not only what should be taxed but also the manner in which the tax may be imposed. Courts are extremely circumspect in questioning the reasonability of such classification but after a "judicial generosity is extended to legislative wisdom, if there is writ on the statute perversity,

25 2005 AIR (SC) 3020.

madness in the method or gross disparity, judicial credibility may snap and the measure may meet with its funeral".

56. These principles must guide the determination by this Court on the constitutional challenge to sub sections (2) and (3) of Section 14A and to Rule 8D. A fundamental basis of the challenge addressed before the Court is the prescription of a uniform method for determining the disallowance of expenditure incurred in relation to income which does not form a part of the total income under the Act. The challenge is that the law and the subordinate legislation operate in situations which are unequal by prescribing a uniform method to assessees who are not similarly situated. The challenge is to the treatment of unequals equally.

57. Now in dealing with the challenge it is necessary to advert to the position that sub section (2) of Section 14A prescribes a uniform method for determining the amount of expenditure incurred in relation to income which does not form part of the total income only in a situation where 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. It therefore merits emphasis that sub section (2) of Section 14A does not authorize or empower the Assessing Officer to apply the prescribed method irrespective of the nature of the claim made by the assessee. The Assessing Officer has to first consider the correctness of the claim of the assessee having regard to the accounts of the assessee. The satisfaction of the Assessing Officer has to be objectively arrived at on the basis of those accounts and after considering all the relevant facts and circumstances. The application of the prescribed method arises in a situation where the claim made by the assessee in respect of expenditure which is relatable to the earning of income which does not form part of the total income under the Act is found to be incorrect. In such a situation a method had to be devised for apportioning the expenditure incurred by the assessee between what is incurred in relation to the earning of taxable income and that which is incurred in relation to the earning of non-taxable income. As a matter of fact, the memorandum explaining the provisions of the Finance Bill 2006 and the CBDT circular dated 28 December 2006 state that since the existing provisions of Section

14A did not provide a method of computing the expenditure incurred in relation to income which did not form part of the total income, there was a considerable dispute between tax payers and the department on the method of determining such expenditure. It was in this background that sub section (2) was inserted so as to provide a uniform method applicable where the Assessing Officer is not satisfied with the correctness of the claim of the assessee. Sub section (3) clarifies that the application of the method would be attracted even to a situation where the assessee has claimed that no expenditure at all was incurred in relation to the earning of non-taxable income.

58. Parliament has provided an adequate safeguard to the invocation of the power to determine the expenditure incurred in relation to the earning of non-taxable income by adoption of the prescribed method. The invocation of the power is made conditional on the objective satisfaction of the Assessing Officer in regard to the correctness of the claim of the assessee, having regard to the accounts of the assessee. When a statute postulates the satisfaction of the Assessing Officer "Courts will not readily defer to

the conclusiveness of an executive authority's opinion as to the existence of a matter of law or fact upon which the validity of the exercise of the power is predicated". **(M.A. Rasheed v. The State of Kerala[26]).** A decision by the Assessing Officer has to be arrived at in good faith on relevant considerations. The Assessing Officer must furnish to the assessee a reasonable opportunity to show cause on the correctness of the claim made by him. In the event that the Assessing Officer is not satisfied with the correctness of the claim made by the assessee, he must record reasons for his conclusion. These safeguards which are implicit in the requirements of fairness and fair procedure under Article 14 must be observed by the Assessing Officer when he arrives at his satisfaction under sub section (2) of Section 14A. As we shall note shortly hereafter, sub rule (1) of Rule 8D has also incorporated the essential requirements of sub section (2) of Section 14A before the Assessing Officer proceeds to apply the method prescribed under sub rule (2).

-59. The charge of the assessee that there is an inherent

26 AIR 1974 SC 2249. (at para 7 page 2252).

arbitrariness in prescribing a uniform method for determining the disallowance of expenditure in relation to the earning of non-taxable income must therefore fail for three reasons. Firstly, as a matter of fundamental principle, when the Court is confronted with a challenge to a classification by tax legislation either on the ground of over or under inclusion, it is trite law that the Court must defer to the wisdom of the legislature. Crudities and inequities are involved in making complex fiscal adjustments that are intrinsic to any fiscal measure. Diverse methods are open to the legislature to achieve a result and if the legislature adopts a particular method, the Court will not substitute its own view for that of the legislature merely because another method appears more suitable or because a better crafted measure could have been put into place. Unless the method which has been selected is capricious, fanciful or arbitrary, the Court will defer to the wisdom of the legislature and to its delegate who is subject to its legislative control. Burdens and disadvantages are not ground enough to strike down the constitutional validity of legislation or subordinate legislation. Cases of individual hardship are similarly not a valid ground for striking down constitutional validity. So long as the

measure which has been put into place has nexus with the object sought to be achieved, is passes constitutional muster. Secondly, sub section (2) of Section 14A makes it abundantly clear that the power to apply the prescribed method arises only where the Assessing Officer is not satisfied with the correctness of the claim of the assessee having regard to the accounts of the assessee. It is because the assessee is unable to establish the correctness of the claim in respect of the expenditure incurred in earning income which does not form part of the taxable income that the Assessing Officer is compelled to make a determination. The Learned Additional Solicitor General has placed before the Court material that would indicate that if a simplistic pro-rata disallowance were to be made, that would as a matter of fact have resulted in a disallowance of Rs.82 Crores on an expenditure of Rs.189.77 Crores. As opposed to this the disallowance under Rule 8D(2)(iii) is restricted to Rs.1.57 Crores. Before the legislature prescribed a uniform method, disputes had occurred between assessees and the department in regard to the method to be adopted in computing the expenditure relatable to the earning of non-taxable income. In this background, if the legislature considered it appropriate to

prescribe a particular method that legislative choice cannot be held to be arbitrary or oppressive. Thirdly, sub sections (2) and (3) and the proviso to Section 14A contain sufficient safeguards that would ensure a reasonable exercise of power. Apart from the safeguards to which a reference has been made earlier, the proviso stipulates that nothing contained in the Section shall empower the Assessing Officer to reassess under Section 147; or enhance the assessment or reduce the refund already made; or otherwise increase the liability of the assessee under Section 154, for any assessment year beginning on or before 1 April 2001.

-60. In the affidavit in reply that has been filed on behalf of the Revenue an explanation has been provided of the rationale underlying Rule 8D. In the written submissions which have been filed by the Additional Solicitor General it has been stated, with reference to Rule 8D(2)(ii) that since funds are fungible, it would be difficult to allocate the actual quantum of borrowed funds that have been used for making tax free investments. It is only the interest on borrowed funds that would be apportioned and the amount of expenditure by way of interest that will be taken (as 'A'

in the formula) will exclude any expenditure by way of interest which is directly attributable to any particular income or receipt (for example – any aspect of the assessee's business such as plant/ machinery etc.). As regards Rule 8D(2)(iii) it has been submitted that some mechanism or formula had to be adopted for attributing part of the administrative /managerial expenses to tax exempt investment income. The administrative expenses attributable to tax free investment income have a fixed component and a variable component. A view was taken that the disallowance should also be linked to the value of the investment rather than the amount of exempt income. Under Portfolio Management Schemes (PMS) the fee charged ranges between 2 and 2.5% of the portfolio value which would be inclusive of a profit element for the portfolio manager. While the fixed administrative expenses were excluded, on the ground that in the case of a large corporate tax payer they would be spread over a large number of voluminous activities, the variable expenses were computed at one-half percent of the value of the investment. The justification that has been offered in support of the rationale for Rule 8D cannot be regarded as being capricious, perverse or arbitrary. Applying the tests formulated by

the Supreme Court it is not possible for this Court to hold that there is writ on the statute or on the subordinate legislation perversity, caprice or irrationality. There is certainly no 'madness in the method'.

C.4 **Retrospectivity**

61. On behalf of the assessee it has been urged that sub sections (2) and (3) of Section 14A and Rule 8D cannot have retrospective effect. Counsel submitted that procedural laws are those which merely prescribe the manner in which rights and responsibilities may be exercised and enforced in a Court. Rule 8D which lays down the rules for determining the amount of disallowance under Section 14A, it has been urged, cannot be regarded as a procedural rule but, is a provision which purports to determine the income which is chargeable to tax. Moreover, it has been urged that Rule 8D has adopted an artificial method for computing the disallowance of expenditure attributable to the earning of non-taxable income and it is not one out of several well accepted or well settled modes of computation. Hence, it was submitted that the present case is distinguishable from the

situation which arose before the Supreme Court in **Commissioner of Wealth Tax v. Sharvan Kumar Swarup and Sons**[27]. Further, reliance was placed on Section 295(4) which specifically provides that no retrospective effect could be given to a rule so as to prejudicially affect the interest of the assessee. Sub sections (2) and (3) were inserted into Section 14A by the Finance Act of 2006 with effect from 1 April 2007. Rule 8D was inserted by the Income Tax Act (Fifth Amendment) Rules 2008 which were published in the Gazette on 24 March 2008. The rules specifically provide that they shall come into force from the date of their publication in the Official Gazette. These provisions, it was urged, cannot be applied to Assessment Year 2002-03 which is under consideration as it is the law prevalent on the first day of April of an assessment year that would have to be applied. In any event where different dates are provided for the enforcement of diverse provisions of Section 14A, sub sections (2) and (3) cannot be regarded as being retrospective.

62. On the other hand, it has been urged on behalf of the

27 (1994) 210 ITR 886.

Union Government, that (i) The provisions of Section 14A(2) and Rule 8D are procedural and provide only a machinery for the implementation of the principle of apportionment; (ii) Machinery provisions by which a charging section is to be implemented or made workable or prescribing the circumstances in which the charging power can be exercised are to be given retrospective effect which is co-terminus with the period of operation of the main charging provision; (iii) The presumption against restrospectivity would not apply to a curative or declaratory provision, when the intent of Parliament is to override an erroneous judicial interpretation of the existing law and to declare what the position in law already was. Section 14A(1) merely sought to correct an erroneous judicial interpretation in relation to the apportionment of expenses; (iv) Rule 8D in the present case is clarificatory of how the primary legislation is to be implemented since (i) it only clarifies the method which could have been followed by the Assessing Officer in any case for determining how much of the deduction claimed had proximate relation with the exempt income and (ii) it would render workable in a uniform manner the parliamentary intent under Section 14A(1); and (v)

The date which has been stated in the Amending Act from which the amendment is to have effect is irrelevant and the Court has to analyze the nature of the provision to determine whether it should be applied retrospectively. These submissions now fall for determination.

63. The fundamental principle of law is that Parliament has plenary power to legislate, on matters falling within its legislative competence and that power extends to the enactment of legislation with prospective and retrospective effect. Legislative competence of Parliament to enact the law is not in dispute. Law raises a presumption that an amendment which affects substantive rights and obligations is intended by the legislature to have prospective effect. On the other hand, amendments on matters of procedure are presumed to be retrospective so as to apply to pending cases. These are, however, presumptions which can be out weighed by the language of an amending statute. That is because the legislature has plenary power to legislate both prospectively and retrospectively. Therefore whether an amending provision is to operate with prospective or retrospective effect has to be

determined on the language and ambit of the statutory provision. Amendments which are clarificatory or declaratory of the position in law, as the legislature intended it always to be, are regarded as being retrospective. Hence, when the legislature steps in by amending the law to set right an incorrect judicial interpretation, an inference can be drawn that the amendment was intended to be retrospective. An amendment which is inserted to remedy unintended consequences and to make a provision workable or which supplies an obvious omission and is required to be read into a section to give it reasonable interpretation has been treated as retrospective in operation.

64. These principles emerge from the precedent on the subject :

(i) In **Income Tax Officer v. M.C.Ponnoose**[28], the Supreme Court dealt with a case where Section 2(44) containing the definition of the expression 'Tax Recovery Officer' was substituted by the Finance Act of 1963 and it was provided that the new definition shall be and shall be deemed always to have been

28 (1970) 75 ITR 174.

substituted. As amended, Clause (ii) of Section 2(44) empowered the State Government to authorize by notification certain land revenue officers to exercise the powers of a tax recovery officer. The State Government issued a notification dated 14 August 1963 which was published in the gazette on 20 August 1963 authorizing various revenue officers to exercise the powers of the Tax Recovery Officer. The notification stated that it shall come into force on 1 April 1962. The Tahsildar had effected an attachment subsequent to 1 April 1962 but prior to 14 August 1963. The Supreme Court held thus :

> "Where any rule or regulation is made by any person or authority to whom such powers have been delegated by the legislature it may or may not be possible to make the same so as to give retrospective operation. It will depend on the language employed in the statutory provision which may in express terms or by necessary implication empower the authority concerned to make a rule or regulation with retrospective effect. But where no such language is to be found it has been held by the courts that the person or authority exercising subordinate legislative functions cannot make a rule, regulation or bye-law which can operate with retrospective effect (see Subba Rao J. in Dr. Indramani Pyarelal Gupta v. W.R. Natu[29] - the majority not having expressed any different opinion on the point ; Modi Food Products Ltd. v. Commissioner of Sales Tax[30]; India Sugars Refineries Ltd. v. State of Mysore[31] and General S. Shivdev

29 [1963] 1 S.C.R. 721 : AIR 1963 SC 274.
30 {1955) 6 S.T.C. 287 : AIR 1956 All 35.
31 AIR 1960 Mys. 326.

Singh v. State of Punjab[32]).”

(ii) In **Allied Motors (P) Ltd. v. Commissioner of Income Tax**[33], the Supreme Court considered the provisions of Section 43-B of the Income Tax Act, 1961 which were aimed at curbing activities of those tax payers who did not discharge their statutory liability towards payment of excise duty, employer’s contribution to provident fund etc. for long periods of time, but claimed deductions on the ground that the liability to pay had been incurred in the relevant previous year. While inserting Section 43-B it was not realized that its language would cause hardship to those tax payers who had paid sales tax within the statutory period prescribed for payment although the payment did not fall in the relevant previous year. This was because the sales tax collected pertained to the last quarter of the relevant accounting year and could be paid only in the next quarter which fell in the next accounting year. Hence, though the sales tax had been paid by an assessee within the statutory period prescribed and prior to the filing of the income tax return, the assessee was unwittingly

32 (1959) P.L.R. 514 (F.B.)
33 (1997) 91 Taxman 205 (SC).

prevented from claiming a deduction. This was not intended by Section 43B. An amendment was made by the Finance Act of 1987 by the insertion of the first proviso. The Supreme Court held that the amendment was curative in nature and hence, the proviso which was inserted by the Finance Act of 1987 should be given retrospective effect from the date of the inception of Section 43B. The Supreme Court held that the first proviso was remedial in nature, designed to eliminate unintended consequences which may cause undue hardship to an assessee and which made the provision unworkable or unjust in a specific situation:

> "A proviso which is inserted to remedy unintended consequences and to make the provision workable, a proviso which supplies an obvious omission in the section and is required to be read into the section to give the section a reasonable interpretation, requires to be treated as retrospective in operation so that a reasonable interpretation can be given to the section as a whole."

(iii) In **Commissioner of Income Tax v. Podar Cement (P) Ltd.**[34], the Supreme Court considered the provisions of Section 27 of the Income Tax Act, 1961 under which certain persons who are not otherwise legal owners were deemed to be owners for certain

34 (1997) 226 ITR 627.

purposes. The Finance Bill of 1987 sought to enlarge the meaning of the expression "owner of house property" in Clause (iii) of Section 27 by providing that a person who comes to have control over the property by virtue of such transactions as are referred to in Section 269 UA(f) will also be deemed to be the owner of the property. The Supreme Court held that the amendment was intended to supply an obvious omission or to clear up doubts as to the meaning of the word "owner" in Section 22 and was therefore declaratory or clarificatory.

(iv) In **Commissioner of Income Tax v. Alom Extrusions Ltd.**[35] the Supreme Court considered the provisions of Section 43B of the Income Tax Act 1961. By way of the first proviso an incentive / relaxation was given in respect of tax, duty, cess or fee by stating that if this was paid before the date of filing of the return under the Income Tax Act, the assessee would be entitled to a deduction. This relaxation, however, did not apply to contributions to labour welfare funds. By the Finance Act of 2003 uniformity was brought about by equating the payment of tax, duty, cess and

35 319 ITR 206 (SC).

fee with contributions to welfare funds. The Finance Act of 2003 was made applicable only with effect from 1 April 2004. Hon'ble Mr. Justice S.H. Kapadia (as the Learned Chief Justice then was) speaking for the Supreme Court held that it was curative in nature and would apply retrospectively with effect from 1 April 1988;

(v) In **Commissioner of Wealth Tax v. Sharvan Kumar Swarup and Sons**[36], Rule 1BB of the Wealth Tax Rules 1967 came up for consideration. Prior to its amendment on 1 April 1989 Section 7(1) of the Wealth Tax Act provided that subject to any rules made in this behalf, the value of any asset other than cash, shall be estimated to be the price which in the opinion of the wealth tax officer it would fetch if sold in the open market on the valuation date. Under Rule 1BB the value of a house used for residential purposes was to be determined in a particular manner. The issue before the Supreme Court was whether this rule was a provision of substantive law, not expressly applicable to valuation for earlier years and therefore only prospective or whether it was merely procedural and would apply to all pending cases. The

36 (1994) 210 ITR 886.

Supreme Court held that Rule 1BB "**merely provides a choice amongst well known and well settled modes of valuation**". Chief Justice M.N. Venkatachaliah speaking for the Court held that even in the absence of Rule 1BB there would have been no legal impediment to adopt the mode of valuation embodied in Rule 1BB by adopting the method of capitalization of income on a number of years' purchase value. The rule, held the Supreme Court, was intended to impart uniformity in valuations and to avoid vagaries and disparities resulting from the application of different modes of valuation in different cases where the nature of the property is similar. Rule 1BB was held to be "essentially a rule of evidence as to the choice of one of the well accepted methods of valuation in respect of certain kinds of properties with a view to achieving uniformity in valuation and avoiding disparate valuations resulting from application of different methods of valuation respecting properties of a similar nature and character."

(vi) In **Associated Cement Company Ltd. v. Commercial Tax Officer**[37], the Supreme Court held that Section 7 of the

37 (1981) 4 SCC 578.

Rajasthan Sales Tax Act 1954 which dealt with the submission of returns was not a charging section but a machinery section. The Court held that while charging provisions have to be construed strictly, machinery sections are not generally subject to a rigorous construction. In other words, machinery sections have to be construed in a manner such that the charge to tax is not defeated. The principle that arises from the case is that a machinery section should be so construed as to give effect to a charging provision. A machinery section must bear interpretation in accordance with the ordinary rules of construction which is that it must be construed in accordance with the clear intent of the legislature to make the charge levied effective.

-(vii) **Sedco Forex International Drill Inc. v. Commissioner of Income Tax**[38] was a case where the Supreme Court considered whether the salary of an employee payable for field breaks outside India would be subjected to tax under Section 9(1)(ii) read with the explanation thereto in the Income Tax Act 1961. Under Section 5(2) the scope of total income as regards a non-resident

38 (2005) 279 ITR 310 (SC)

was defined with reference to the receipt or accrual in India, whether deemed or actual. Section 9 defines income deemed to accrue or arise in India. By Clause (ii) of sub section (1) of Section 9, income which falls under the head 'salaries', if it is earned in India is included in such income. The Gujarat High Court had held that the words "earned in India" had to be interpreted as "arising or accruing in India" and not "from service rendered in India". Hence, as long as the liability to pay an amount under the head 'salaries' arose in India, Clause (ii) could be invoked. To overcome this decision, Section 9(1)(ii) was amended by the Finance Act of 1983 with effect from 1 April 1979 to include an explanation. The explanation provided that income of the nature referred to in the Clause payable for service rendered in India shall be regarded as income earned in India. The Gauhati High Court held that the explanation of 1983 was given effect from 1 April 1979 and would therefore not apply to assessment years prior thereto. By the Finance Bill of 1999 a new explanation was substituted with effect from 1 April 2000 which declared that income of the nature referred to in the clause payable for service rendered in India and the rest period or leave period which is preceded and succeeded by

services rendered in India and forms part of the service contract shall be regarded as income earned in India. The Supreme Court held that given the legislative history of Section 9(1)(ii) it was only to be assumed that the explanation was deliberately introduced with effect from 1 April 2000 and was therefore intended to apply prospectively. The Supreme Court adverted to three circumstances : firstly, the departmental understanding of the effect of the 1999 amendment as contained in a circular of the Central Board of Direct Taxes afforded a reasonable construction thereof and there was no reason why the Supreme Court should not adopt it. Secondly, the cardinal principle of tax law is that the law to be applied is that in force in the relevant assessment year unless otherwise provided expressly or by necessary implication. Thirdly, where an explanation to a statutory provision merely clears up an ambiguity or is clarificatory, it must be read into the main provision with effect from the time when the main provision came into force. But if it changes the law, it is not presumed to be retrospective irrespective of the fact that the phrases used are “it is declared” or “for the removal of doubts”. In that case, where the explanation sought to give an artificial meaning to the expression

"earned in India" and to bring about a change effectively in the existing law and in addition it was stated to come into force with effect from a future date, no principle of interpretation would justify reading the provision retrospectively.

(viii) In **Deputy Commissioner of Income Tax v. Core Health Care Limited**,[39] the Supreme Court construed the provisions of a proviso inserted into Section 36(1)(iii) of the Income Tax Act, 1961 by the Finance Act of 2003 with effect from 1 April 2004. The Supreme Court held that the proviso would not apply to Assessment Years 1992-93 to 1997-98.

(ix) In **Commissioner of Income Tax v. Gold Coin Health (P) Ltd.**,[40] the question which arose before a larger Bench of the Supreme Court was whether a penalty under Section 271(1)(c) of the Income Tax Act, 1961 could be levied if the returned income was a loss. This question had to be considered in the background of the amendment made by the Finance Act of 2002 with effect from 1 April 2003 in Explanation 4 to Section 271(1)(c) (iii). In

39 (2008) 298 ITR 194
40 304 ITR 308 (SC)

its earlier decision in the case of **Virtual Soft Systems Ltd. v. Commissioner of Income Tax,**[41] the Supreme Court had rejected the contention of the Revenue that the amendment was clarificatory and retrospective holding that the amendment was stated to take effect from 1 April 2003. In **Gold Coin** the larger Bench held that the Court has to analyze the nature of the amendment to come to a conclusion whether it is in reality a clarificatory or declaratory provision. Hence, the date from which the amendment is made operative does not conclusively decide the question. The Court would have to examine the scheme of the statute prior to the amendment and subsequent to the amendment to determine whether the amendment is clarificatory or substantive. Adverting to its earlier decision, the Supreme Court held that the definition of the expression 'income' in Section 2(24) is inclusive and includes losses. The Finance Act had merely intended to make what was otherwise implied, explicit. Since the expression 'income' had been held by the Supreme Court to include losses, consequently where in a case on account of addition of concealed income the loss returned stands reduced, a penalty

41 (2007) 9 SCC 665

would be leviable even prior to 1 April 2003 if the final assessed income is the loss. The amendment was therefore regarded as being clarificatory in nature.

65. The following principles guide in determining as to whether an amendment is prospective or retrospective:

(i) In determining as to whether an amendment is to take effect prospectively or with retrospective effect, the date from which the amendment is made operative does not conclusively decide the question. The Court has to examine the scheme of the statute prior to the amendment and subsequent to the amendment to determine whether an amendment is clarificatory or substantive;

(ii) An amendment which is clarificatory is regarded as being retrospective in nature and would date back to the original statutory provision which it seeks to amend. A clarificatory amendment is an expression of intent which the legislature has always intended to hold the field. A clarificatory amendment may be introduced in certain cases to set at rest divergent views

expressed in decided cases on the true effect of a statutory provision. Where the legislature clarifies its intent, it is regarded as being declaratory of the law as it always stood and is therefore, construed to be retrospective;

(iii) Where on the other hand, an amendment seeks to bring about a substantive change in legal rights and obligations, the Court would not readily accept an interpretation of the amendment that would render it retrospective in character. Clear words will be necessary in order to enable the Court to reach to such a conclusion;

(iv) Where the amendment is curative or where it is intended to remedy unintended consequences or to render a statutory provision workable, the amendment may be construed to relate back to the provision in respect of which it supplies a remedial effect;

(v) Where an amendment essentially provides a rule of evidence such as a method for the valuation of the property by

adopting one among a set of well known and well accepted methods of valuation with a view to achieve uniformity in valuation and avoiding disparate valuations resulting from the application of different methods in respect of properties of a similar nature and character, the Court would place a construction on the statutory provision, giving the retrospective effect.

66. These principles would have now to be construed in the context of the provisions of Section 14A. The first point to be noted about the provisions of Section 14A and Rule 8D is that different dates have been provided in these provisions for their enforcement : (i) Sub section (1) of Section 14A was inserted by the Finance Act of 2001 with retrospective effect from 1 April 1962; (ii) Sub sections (2) and (3) were inserted in Section 14A by the Finance Act of 2006 with effect from 1 April 2007; (iii) The proviso was inserted by the Finance Act of 2002 with retrospective effect from 11 May 2001; (iv) Rule 8D was inserted by the Income Tax (Fifth Amendment) Rules, 2008 by publication in the Gazette dated 24 March 2008. Sub rule (2) of Rule 1 stipulates that the rules shall come into force from the date of their publication in the

Official Gazette. This by itself is not conclusive. Secondly, prior to the insertion of Section 14A by the Finance Act of 2001 the Supreme Court had held in its decisions in **Indian Bank, Maharashtra Sugars and Rajasthan State Warehousing Corporation** (supra) that in the case of a composite and indivisible business which resulted in taxable and non-taxable income, it was impermissible for the Assessing Officer to apportion the expenditure incurred in relation to such business as between the earning of taxable and non-taxable income. Sub section (1) of Section 14A was inserted with retrospective effect from 1 April 1962 to overcome the decisions of the Supreme Court. At the same time, as has been noticed by the Supreme Court in its decision in **Wolfort**, the theory of apportionment of expenditure between taxable and non-taxable income has, in principle, been now widened under Section 14A. Reading Section 14 in juxtaposition with Sections 15 to 59, it has been observed that the words "expenditure incurred" in Section 14A refer to expenditure on rent, tax, salary, interest etc. in respect of which allowances are provided for. Thirdly, sub sections (2) and (3) were introduced by a legislative amendment brought about by the Finance Act of 2006.

The memorandum explaining the provisions of the Finance Bill of 2006 recognizes that the existing provisions of Section 14A did not provide a method of computing the expenditure incurred in relation to income which does not form part of the total income. Consequently, there was a considerable amount of dispute between the tax payers and the department on the method of determining such expenditure. It was in view of these disputes that Parliament inserted a new sub section (2) to permit the framing of subordinate legislation to provide a mandatory method for the Assessing Officer to follow in determining the expenditure incurred in relation to income which does not form part of the total income, if the Assessing Officer was not satisfied with the correctness of the claim of the assessee. The memorandum provided that "this amendment will take effect from 1 April 2007 and will, accordingly apply in relation to the Assessment Year 2007-08 and subsequent years". A circular was issued by the CBDT on 28 December 2006 once again clarifying the position that the amendment would be applicable "from the Assessment Year 2007-08 onwards". At any rate this construction which has been placed on the amendment both in the memorandum explaining the provisions of the Finance Bill of 2006

and in the circular of the CBDT dated 28 December 2006 can be regarded as a reasonable interpretation of the provision as explained by the Supreme Court in its judgment in **Sedco** (supra). The fourth aspect of the matter which would merit emphasis, is the principle of law which has been laid down by the Supreme Court in **Shravan Kumar**'s case (supra). The test which has been formulated by the Supreme Court is as to whether the rule which is prescribed by subordinate legislation "merely provides a choice amongst well known and well settled modes" – in that case of valuation. In the case before the Supreme Court, the rule under the Wealth Tax Rules had adopted the method of capitalizing income on a number of years' purchase value. The Supreme Court emphasized that this was essentially a rule of evidence as to the choice of one of the well accepted methods of valuation to achieve uniformity in valuation resulting from the application of different methods to properties of a similar nature and character. The learned Additional Solicitor General has argued before us that the fact that Rule 8D is not in that sense an embodiment of a "well known and well settled mode" or a "well accepted method" is no indicator in regard to its reasonableness. We have upheld the

contention of the Union of India that Rule 8D is reasonable in its nature. That, however, is not dispositive of the question as to whether the rule can be regarded as prospective or retrospective in nature. In determining as to whether a rule in a piece of subordinate legislation is to be regarded as prospective or retrospective, an important aspect that has been emphasized by the Supreme Court in the aforesaid decision is as to whether the rule embodies what is essentially a well known, a well settled or well accepted method. As a matter of fact in the present case there can be no doubt about the position that Rule 8D has essentially put into place an artificial method of estimating the expenditure that can be regarded as being relatable to income that does not form part of the total income under the Act. The learned Additional Solicitor General has both in the course of the oral arguments as well as in the written submissions emphasized before the Court that if the pro-rata method were to be applied in the alternative to the method provided in Rule 8D(2)(iii), the amount of disallowance would be immense and would almost be disproportionate. In the case of the Appellant itself, for the assessment year under consideration, on an expenditure of Rs.189.77 Crores the

disallowance under the pro-rata method would be to the extent of Rs.82 Crores. However, under the measure of 0.5% provided by Rule 8D(2)(iii), the disallowance has been computed at Rs.1.57 Crores. Before the insertion of Section 14A, there was no specific method of determining the expenditure incurred in relation to non-taxable income. Looking at the totality of the circumstances, the measure of 0.5% is reasonable. Hence, while we have held that the method of computation provided in Rule 8D is fair and reasonable to pass muster under Article 14, we are nonetheless of the view that the method must take effect prospectively. Finally, Sub-section (4) of Section 295 of the Act provides as follows :

> "(4) The power to make rules conferred by this section shall include the power to give retrospective effect, from a date not earlier than the date of commencement of this Act, to the rules or any of them and, unless the contrary is permitted (whether expressly or by necessary implication), no retrospective effect shall be given to any rule so as to prejudicially affect the interests of assessees."

Sub-section (4) empowers the rule making authority to give retrospective effect to subordinate legislation. However, unless expressly or by necessary indication, a contrary provision is made,

no retrospective effect is to be given to any rule so as to prejudicially affect the interests of the assessee.

67. Even in the absence of sub sections (2) and (3) of Section 14A and of Rule 8D, the Assessing Officer was not precluded from making apportionment. Such an apportionment would have to be made in order to give effect to the substantive provisions of sub section (1) of Section 14A which provide that no deduction would be allowed in respect of expenditure incurred in relation to income which does not form part of the total income under the Act. Consequently, dehors the provisions of Sections (2) and (3) of Section 14A and Rule 8D, the Assessing Officer was entitled to determine by the application of a reasonable method what quantum of the expenditure incurred by the assessee would have to be disallowed on the ground that it was incurred in relation to the earning of income which does not form part of the total income under the Act. Undoubtedly in determining what would constitute a reasonable method for effecting the disallowance, the Assessing Officer would have to give due regard to all the facts and circumstances of the case. The change which is brought about by

the insertion of sub sections (2) and (3) into Section 14A by the Finance Act of 2006 with effect from 1 April 2007 is that in a situation where the Assessing Officer is not satisfied with the correctness of the claim of the assessee in regard to the expenditure incurred by it in relation to the non-taxable income, the Assessing Officer would have to follow the method which is prescribed by the rules. The rules were notified to come into force on 24 March 2008. It is a trite principle of law that the law which would apply to an assessment year is the law prevailing on the first day of April. Consequently, Rule 8D which has been notified on 24 March 2008 would apply with effect from Assessment Year 2008-09. The rule consequently cannot have application in respect of Assessment Year 2002-03 which is the year under consideration in this case.

C.5 <u>The order of restoration passed by the Tribunal</u>

68. In the present case, the Tribunal has relied upon its judgment in the case of **<u>Daga Capital Management Pvt. Ltd</u>.**, in coming to the conclusion that the provisions of sub sections (2) and (3) of Section 14A are procedural in nature and therefore retrospective. Having held thus, the Tribunal observed that under

sub section (2) of Section 14A, the Income Tax Officer was required to satisfy himself as regards the correctness of the claim of the assessee. The Tribunal noted that the Assessing Officer had not examined the issue in the light of the provisions of Section 14A(2) (which were not enacted at the time when the assessment order was passed). Hence, the Tribunal directed that the Assessing Officer to examine the issue denovo in view of the provisions of Section 14A(2).

69. For the reasons which we have noted earlier, we have come to the conclusion that the provisions of Rule 8D shall have no application to Assessment Year 2002-03 which is the year under consideration in this case. At the same time, as we have noted, Section 14A(1) would have to be given effect to. The principle underlying Section 14A(1) is that no deduction can be claimed in respect of the expenditure incurred in relation to income which does not form part of the total income under the Act. The dividend income earned by the assessee for Assessment Year 2002-03 does not form part of the total income in view of the provisions of Section 10(33) as they then stood. Hence, the expenditure which

has been incurred in relation to the earning of that income would have to be apportioned and disallowed. Even if Rule 8D has no application to Assessment Year 2002-03 the Assessing Officer would be duty bound to compute the extent of the disallowance by the application of a reasonable method having regard to all the facts and circumstances of the case. In order to facilitate this exercise, an order of remand to the Assessing Officer would be necessary.

70. However, it has been urged on behalf of the assessee that there is no factual basis for making a disallowance in view of the findings recorded by the Tribunal for Assessment Years 1998-99, 1999-00 and 2001-02. Hence, it was urged that the Tribunal had wrongly restored the proceedings to the Assessing Officer. Now a perusal of the findings of the Tribunal for Assessment Year 1998-99 would show that the Tribunal held that no nexus between the investments made by the assessee in dividend earning shares and borrowings by the assessee has been established. This order was followed for Assessment Years 1999-00 and 2001-02. Counsel appearing on behalf of the

assessee submitted that as against its investments in income yielding shares / units of mutual funds of Rs.125.54 Crores on 31 March 2002, the assessee had a share capital of Rs.6.55 Crores and reserves and surplus of Rs.274.09 Crores aggregating to Rs.280.64 Crores. The inference which is sought to be drawn on behalf of the assessee by counsel is that the investments were made by the assessee out of its own funds. Moreover, it has been submitted that the investment which stood at Rs.127.20 Crores was reduced as on 31 March 2002 to Rs.125.54 Crores and there was a decrease in the investment during the previous year under consideration. Counsel placed reliance on the judgment of the Supreme Court in **Radhasoami Satsang v. Commissioner of Income Tax**[42] to urge that though strictly speaking *res judicata* does not apply to income tax proceedings each assessment year being a unit itself, where a fundamental aspect permeating through different assessment years has been found as a fact one way or the other and parties have allowed that position to be sustained, it would not be appropriate to allow the position to be changed in a subsequent year. Reliance was also sought to be placed upon the decisions of the Karnataka

42 (1992) 193 ITR 321 (SC).

High Court in **Commissioner of Income Tax v. Sridev Enterprises**[43]; of a Division Bench of this Court in **Commissioner of Income Tax v. Reliance Utilities and Power Ltd.**[44] and on the decision of the Supreme Court in **Munjal Sales Corporation v. Commissioner of Income Tax**[45].

71. Now before we deal with the judgments on which reliance has been placed, it is necessary to appreciate the basis of the decisions of the Tribunal for Assessment Years 1998-99, 1999-00 and 2001-02. In all these decisions, the Tribunal held that no nexus had been established between borrowed funds and investments by the assessee in dividend yielding shares / income yielding mutual funds. Now assuming that this is so, the only conclusion which emerges is that the assessee had utilized its own funds for the purpose of making the investments. The fact that the assessee has utilized its own funds in making the investments would not be dispositive of the question as to whether the assessee had incurred expenditure in relation to the earning of such income. Even if the assessee has utilized its own funds for making

43 (1991) 192 ITR 165.
44 (2009) 313 ITR 340 (Bom).
45 (2008) 298 ITR 298 (SC).

investments which have resulted in income which does not form part of the total income under the Act, the expenditure which is incurred in the earning of that income would have to be disallowed. That is exactly a matter which the Assessing Officer has to determine. Whether or not any expenditure was incurred by the assessee in relation to the earning of non-taxable income falls within the domain of the Assessing Officer. The basis on which the Tribunal had come to its decision for Assessment Years 1998-99, 1999-00 and 2001-02 would not conclude that question.

72. The precedents on which reliance has been placed by the assessee would have now to be analyzed. The Supreme Court in its judgment in **Radhasoami Satsang (**supra) held that *res judicata* does not apply to income tax proceedings since each assessment year is a unit. However, where a fundamental aspect permeating through different assessment years has been found as a fact one way or the other and parties have allowed that position to be sustained by not challenging that order, it would not be appropriate to allow the position to be changed in a subsequent year, in the absence of any material change justifying the Revenue

to take a different view of the matter. Moreover, in the concluding part of the judgment the Supreme Court has held that this decision "is confined to the facts of the case and may not be treated as an authority on aspects which have been decided for general application"[46]. The decision of the Supreme Court in **Munjal Sales Corporation** (Supra) turned purely on the facts of the case. The Supreme Court noted that the opening balance as on 1 April 1994 was Rs.1.91 Crores whereas the loan given to a sister concern was a small amount of Rs.5 lacs. The profits earned by the assessee during the relevant year were held to be sufficient to cover the loan of Rs.5 lacs. In the decision of the Division Bench of this Court in **Reliance Utilities** (supra) the Division Bench has held that "if there be interest free funds available to an assessee sufficient to meet its investments and at the same time the assessee had raised a loan it can be presumed that the investments were from the interest free funds available". The decision of the Division Bench turned on a finding of fact by the Tribunal that there were sufficient interest free funds available in that case. The judgment in **Reliance Utilities** shows that there were interest free

46 at page 329.

owned funds available and not merely reserves. In **East India Pharmaceutical Works Ltd. v. Commissioner of Income Tax**[47] the Supreme Court in the facts of the case refused to draw any such presumption. In the case of the assessee, the learned Additional Solicitor General has submitted that the reference is made only to reserves and there is no mention of interest free funds. It has been urged that reserves are shown on the liabilities side of the balance-sheet and are represented by a variety of assets on the assets side. These assets could be fixed or non liquid assets and hence not investible. The real enquiry is whether there are interest free funds available on the assets side and in the absence of sufficient proof of available interest free funds, no such presumption can be drawn. Moreover, it has been urged that after the introduction of Section 14A(1), no such presumption can in any event be drawn, since Parliament expressly requires apportionment. We recapitulate our conclusions on this point thus:

a) The ITAT had recorded a finding in the earlier assessments that the investments in shares and mutual funds have been

47 (1997) 224 ITR 627.

made out of own funds and not out of borrowed funds and that there is no nexus between the investments and the borrowings. However, in none of those decisions was the disallowability of expenses incurred in relation to exempt income earned out of investments made out of own funds considered. Moreover, under Section 14A, expenditure incurred in relation to exempt income can be disallowed only if the assessing officer is not satisfied with the correctness of the expenditure claimed by the assessee. In the present case, no such exercise has been carried out and, therefore, the Tribunal was justified in remanding the matter.

b) Section 14A was introduced by the Finance Act 2001 with retrospective effect from 1 April 1962. However, in view of the proviso to that Section, the disallowance thereunder could be effectively made from assessment year 2001-2002 onwards. The fact that the Tribunal failed to consider the applicability of Section 14A in its proper perspective, for assessment year 2001-2002 would not bar the Tribunal from considering disallowance under Section 14A in assessment

year 2002-2003.

c) The decisions reported in **Sridev Enterprises**(supra), **Munjal Sales Corporation** (supra) and **Radhasoami Satsang** (supra) holding that there must be consistency and definiteness in the approach of the revenue would not apply to the facts of the present case, because of the material change introduced by Section 14A by way of statutory disallowance in certain cases. Therefore, the decisions of the Tribunal in the earlier years would have no relevance in considering disallowance in assessment year 2002-2003 in the light of Section 14A of the Act.

73. For the reasons which we have indicated, we have come to the conclusion that under Section 14A(1) it is for the Assessing Officer to determine as to whether the assessee had incurred any expenditure in relation to the earning of income which does not form part of the total income under the Act and if so to quantify the extent of the disallowance. The Assessing Officer would have to arrive at his determination after furnishing an opportunity to the assessee to produce its accounts and to place on the record all

relevant material in support of the circumstances which are considered to be relevant and germane. For this purpose and in light of our observations made earlier in this section of the judgment, we deem it appropriate and proper to remand the proceedings back to the Assessing Officer for a fresh determination.

Conclusion :

74. Our conclusions in this judgment are as follows :

i) Dividend income and income from mutual funds falling within the ambit of Section 10(33) of the Income Tax Act 1961, as was applicable for Assessment Year 2002-03 is not includible in computing the total income of the assessee. Consequently, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to such income which does not form part of the total income under the Act, by virtue of the provisions of Section 14A(1);

ii) The payment by a domestic company under Section 115O(1) of additional income tax on profits declared, distributed or paid is a charge on a component of the profits of the

company. The company is chargeable to tax on its profits as a distinct taxable entity and it pays tax in discharge of its own liability and not on behalf of or as an agent for its shareholders. In the hands of the shareholder as the recipient of dividend, income by way of dividend does not form part of the total income by virtue of the provisions of Section 10(33). Income from mutual funds stands on the same basis;

iii) The provisions of sub sections (2) and (3) of Section 14A of the Income Tax Act 1961 are constitutionally valid;

iv) The provisions of Rule 8D of the Income Tax Rules as inserted by the Income Tax (Fifth Amendment) Rules 2008 are not ultra vires the provisions of Section 14A, more particularly sub section (2) and do not offend Article 14 of the Constitution;

v) The provisions of Rule 8D of the Income Tax Rules which have been notified with effect from 24 March 2008 shall apply with effect from Assessment Year 2008-09;

vi) Even prior to Assessment Year 2008-09, when Rule 8D was not applicable, the Assessing Officer has to enforce the

provisions of sub section (1) of Section 14A. For that purpose, the Assessing Officer is duty bound to determine the expenditure which has been incurred in relation to income which does not form part of the total income under the Act. The Assessing Officer must adopt a reasonable basis or method consistent with all the relevant facts and circumstances after furnishing a reasonable opportunity to the assessee to place all germane material on the record;

vii) The proceedings for Assessment Year 2002-03 shall stand remanded back to the Assessing Officer. The Assessing Officer shall determine as to whether the assessee has incurred any expenditure (direct or indirect) in relation to dividend income / income from mutual funds which does not form part of the total income as contemplated under Section 14A. The Assessing Officer can adopt a reasonable basis for effecting the apportionment. While making that determination, the Assessing Officer shall provide a reasonable opportunity to the assessee of producing its accounts and relevant or germane material having a bearing on the facts and circumstances of the case.

75. The appeal and the writ petition shall stand disposed of accordingly.

76. There shall be no order as to costs.

(Dr. D.Y.Chandrachud, J.)

(J.P. Devadhar, J.)