2024:BHC-OS:3452-DB



**IN THE HIGH COURT OF JUDICATURE AT BOMBAY**
**ORDINARY ORIGINAL CIVIL JURISDICTION**

**INCOME TAX APPEAL NO.492 OF 2004**

Mahesh K. Mehta, residing at 4/45, Sadhana, "J" Road, Churchgate, Mumbai – 400 020 ) ) ) ....Appellant

V/s.

1. Deputy Commissioner of Income Tax, Circle 4(2), Mumbai, having his office at Aayakar Bhavan, Maharshri Karve Road, Mumbai – 400 020 ) ) )

2. Commissioner of Income Tax – 4, Mumbai, having his office at Aayakar Bhavan, 3rd Floor, Maharshri Karve Road, Mumbai – 400 020 ) ) ) ) ....Respondents

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Mr. Mahesh K. Mehta, Appellant present in person.Mr. Suresh Kumar for respondents.

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**CORAM : K. R. SHRIRAM &**
**DR. NEELA GOKHALE, JJ.**
**DATED : 1st MARCH 2024**

**ORAL JUDGMENT (PER K.R. SHRIRAM, J.) :**

1 This petition relates to Assessment Year 1998-1999. The short point in the matter is allowability of interest of Rs.36,88,866/- paid on borrowed amount.

2 Assessee, i.e., appellant, is a Chartered Accountant by qualification and decided to switch profession to become a stock broker. Therefore, in 1987 he acquired membership card of the Bombay Stock Exchange. In 1994 appellant also acquired membership of National Stock Exchange. Appellant admittedly had also borrowed capital which he invested primarily in shares of his own two companies, viz., MKM Shares

and Stock Brokers Ltd. and MKM Finance and Investment Pvt. Ltd. Assesseehad allocated amount of Rs.36,88,866/- interest that he had paid on borrowings for the amounts invested in shares of these two companies.

3 The Assessing Officer disallowed the interest holding that no deduction is to be allowed in respect of expenditure incurred in relation to income which does not form part of the total income under the Income Tax Act, 1961 (the Act). The Assessing Officer observed that the purpose of investment was to earn income in the form of dividend from the two companies and the same was not taxable. The assessment order dated 14th March 2001 was challenged before the Commissioner of Income Tax(Appeals) [CIT(A)]. The CIT(A) held that Section 14A of the Act clearly says that any expenditure incurred in relation to any income which is not included in the total income would not be allowed on expenditure. Sincethe dividend income is not includable in the total income by virtue of Section 10(33) of the Act, whether the dividend income is received or not, the expenditure claimed for such income cannot be allowed in view of provisions of Section 14A and Section 10(33) of the Act. Paragraphs 3.3 and 3.4 of the order of CIT(A) read as under :

> *3.3. Apart from this, section 14A also clearly says that any expenditure incurred in relation to any income which is not included in the total income would not be allowed on expenditure. By virtue of provisions of section 10(33), the dividend income is not includable in the total income. Hence, if the dividend income is received or not, the expenditure claimed for such income cannot be allowed in view of provisions of section 14A and section 10(33).*

> *3.4. As regards the claim of the assessee that this interest should be allowed u/s 36(1)(iii), the shares which are generally held as stock-in-trade by the assessee are in the nature of business assets and the profit arising on purchase and sale of shares is treated as business profit. The activity of purchase and sale of shares is a business activity and any profit or loss on purchase and sale of such shares is normally treated as business profit or loss. This being the case, interest paid on loan for acquiring shares is allowable as business expenditure u/s 36(1)(iii). But in the instant case, shares of a private limited company in which the assessee has invested have been held as investment and not as stock-in-trade. Another most important feature is that a shares of a private limited company cannot be traded in the open market and thus these shares held by the assessee cannot be treated as stock-in-trade. Hence, the question of allowing the interest paid on the loan for acquiring the shares which is not stock-in-trade of the assessee as business expenditure u/s 36(1) (ii) does not arise. Hence, the disallowance of interest amounting to Rs.36,86,866/- is confirmed.*

4 Unhappy with this finding of the CIT(A), appellant/assessee preferred an appeal before the Income Tax Appellate Tribunal (ITAT). The ITAT dismissed the appeal by an order dated 22nd October 2003, which is impugned in this appeal, by holding that the borrowed capital was invested primarily in shares of assessee's own group companies from which assessee did not receive any income and there is nothing on record to indicate how such investment was subservient to the business of assessee and that assessee failed to demonstrate how the borrowed funds were utilised for the purposes of business. The ITAT also proceeded on the admitted facts that the borrowed capital was utilised for acquiring controlling interest in the two companies.

5 Against the order of the ITAT, the present appeal was filed. The appeal came to be admitted on 16th January 2007 and the following

substantial question of law was framed :

> *Whether on the facts and in the circumstances of the case, the Tribunal was justified in law in holding that the interest of Rs.36,88,866/- paid on the borrowings was not allowable as deduction?*

6 Appellant, who appeared in person, submitted that the Apex Court in ***S.A. Builders Ltd. V/s. Commissioner of Income Tax (Appeals) and Anr.***[1] has held that the deduction should be allowed since the expression for the purpose of business would include expenditure voluntarily incurred for commercial expediency. It was submitted that appellant started as individual stock broker who wanted to expand as a corporate entity and itis this business expenditure made it essential for him to use borrowed funds in the two companies. Appellant submitted that loans taken in personal name were duly utilised in acquiring equity shares in two closely held companies fully under his control and effectively the interest was paid on the borrowed utilised in his corporatized business under a clear commercial expediency. In our view, *S.A. Builders Ltd.* (Supra) would not be applicable to the facts of this case inasmuch as that was a case where assessee had borrowed funds from the bank and lent some of it to its sister concern (a subsidiary) as interest free loan and the test was whether that was done as a measure of commercial expediency.

***7*** As rightly submitted by Mr. Suresh Kumar, the facts in this case would squarely be covered by the judgment of the Apex Court in ***Maxopp***

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1 (2007) 288 ITR 1 (SC)

***Investment Ltd. V/s. Commissioner of Income Tax, New Delhi***[2]. The Apex Court held that according to Section 14A(1) of the Act, deduction of that expenditure is not to be allowed which has been incurred by assessee "in relation to income which does not form part of the total income under this Act". Axiomatically, it is that expenditure alone which has been incurred in relation to the income which is includible in total income that has to be disallowed. If an expenditure incurred has no causal connection with the exempted income, then such an expenditure would obviously be treated asnot related to the income that is exempted from tax, and such expenditure would be allowed as business expenditure. In other words, such expenditure would then be considered as incurred in respect of other income which is to be treated as part of the total income.

8 The question that arose before the Apex Court in *Maxopp Investment Ltd.* (Supra) was whether expenditure (including interest paid on funds borrowed) in respect of investment in shares of operating companies for acquiring and retaining a controlling interest therein is hit by Section 14A of the Act inasmuch as the dividend received on such shares does not form part of the total income. Assessee contended that the dominant intention for purchasing the share was not to earn dividends income but control of the business in the company in which shares were invested or for the purpose of trading in the shares as a business activity

etc. In this backdrop, the issue was as to whether the expenditure incurred

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2 (2018) 91 taxmann.com 154 (SC)

can be treated as expenditure "in relation to income", i.e., dividend income, which does not form part of the total income. All the cases before the Apex Court pertain to dividend income, whether it was for the purpose of investment in order to retain controlling interest in a company or in groupof companies or the dominant purpose was to have it as stock in trade. Even in *Maxopp Investment Ltd.* (Supra), during the relevant assessment year, assessee incurred total interest expenditure of Rs.1,61,21,168/-, which was claimed as business expenditure under Section 36(1)(iii) of the Act. Assessee argued that the expenditure claimed was not hit by Section 14A of the Act, on the ground that although borrowed funds were partly utilised for investment in shares held as trading assets, such investment was made with the intention to acquire and retain a controlling interest in the company and that the receipt of dividend thereon was merely incidental.

It was also argued on behalf of assessee that when the shares were acquired, as part of promoter holding, for the purpose of acquiring controlling interest in the company, the dominant object is to keep control over the management of the company and not to earn the dividend from investment in shares. Whether dividend is declared/earned or not isimmaterial and, in either case, assessee would not liquidate the shares in investee companies. Therefore, no expenditure was made "in relation to" the income, i.e., the dividend income and, therefore, Section 14A of the Act would not be attracted.

The Apex Court held that the dominant purpose test for which the investment into shares is made by an assessee may not be relevant while interpreting Section 14A of the Act. The fact remains that such dividend income is non taxable and in that scenario, if expenditure is incurred on earning the dividend income, that much of the expenditure which is attributable to the dividend income has to be disallowed and cannot be treated as business expenditure. Paragraphs 3, 4, 29 and 31 to 35 of *Maxopp Investment Ltd.* (Supra) read as under :

> *3. Though, it is clear from the plain language of the aforesaid provision that no deduction is to 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, the effect whereof is that if certain income is earned which is not to be included while computing total income, any expenditure incurred to earn that income is also not allowed as a deduction. It is well known that tax is leviable on the net income. Net income is arrived at after deducting the expenditures incurred in earning that income. Therefore, from the gross income, expenditure incurred to earn that income is allowed as a deduction and thereafter tax is levied on the net income. The purpose behind Section 14A of the Act, by not permitting deduction of the expenditure incurred in relation to income, which does not form part of total income, is to ensure that the assessee does not get double benefit. Once a particular income itself is not to be included in the total income and is exempted from tax, there is no reasonable basis for giving benefit of deduction of the expenditure incurred in earning such an income. For example, income in the form of dividend earned on shares held in a company is not taxable. If a person takes interest bearing loan from the Bank and invests that loan in shares/stocks, dividend earned therefrom is not taxable. Normally, interest paid on the loan would be expenditure incurred for earning dividend income. Such an interest would not be allowed as deduction as it is an expenditure incurred in relation to dividend income which itself is spared from tax net. There is no quarrel upto this extent.*
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> *4. However, in these appeals, the question has arisen under varied circumstances where the shares/stocks were purchased*

*of a company for the purpose of gaining control over the said company or as 'stock-in-trade'. However, incidentally income was also generated in the form of dividends as well. On this basis, the assessees contend that the dominant intention for purchasing the share was not to earn dividends income but control of the business in the company in which shares were invested or for the purpose of trading in the shares as a business activity etc. In this backdrop, the issue is as to whether the expenditure incurred can be treated as expenditure 'in relation to income' i.e. dividend income which does not form part of the total income. To put it differently, is the dominant or main object would be a relevant consideration in determining as to whether expenditure incurred is 'in relation to' the dividend income. In most of the appeals, including in Civil Appeal Nos.104-109 of 2015, aforesaid is the scenario. Though, in some other cases, there may be little difference in fact situation. However, all these cases pertain to dividend income, whether it was for the purpose of investment in order to retain controlling interest in a company or in group of companies or the dominant purpose was to have it as stock-in-trade.*

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*29. Basing their case on the aforesaid principles, it was argued that when the shares were acquired, as part of promoter holding, for the purpose of acquiring controlling interest in the company, the dominant object is to keep control over the management of the company and not to earn the dividend from investment in shares. Whether dividend is declared/earned or not is immaterial and, in either case, the assessee would not liquidate the shares in investee companies. Therefore, no expenditure was made 'in relation to' the income i.e. the dividend income and, therefore, Section 14A would not be attracted. In this hue, it was submitted that Section 14A was to be accorded plain and grammatical interpretation meaning thereby mandating and requiring a direct and proximate nexus/link between the expenditure actually incurred and the earning of the exempt income. It was also argued that even if contextual/purposive interpretation is to be given, that also called for direct and proximate connection between the expenditure incurred and earning of dividend. According to the learned counsel appearing for the assessees, the legislative intention behind inserting Section 14A in this statute was to exclude both, viz. the receipts which are exempt under the provisions of the Act as well as expenditure actually incurred 'in relation thereto' from entering into the computation of assessable income, so as to remove the double benefit to the assessee (i) in the form of exempt income, on which no tax is leviable; and (ii) providing deduction in respect of expenditure actually incurred which directly resulted in the earning of exempt income by the assessee.*

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*31. We have given our thoughtful consideration to the argument of counsel for the parties on both sides, in the light of various judgments which have been cited before us, some of which have already been taken note of above.*

*32. In the first instance, it needs to be recognised that as per section 14A(1) of the Act, deduction of that expenditure is not to be allowed which has been incurred by the assessee "in relation to income which does not form part of the total income under this Act". Axiomatically, it is that expenditure alone which has been incurred in relation to the income which is includible in total income that has to be disallowed. If an expenditure incurred has no causal connection with the exempted income, then such an expenditure would obviously be treated as not related to the income that is exempted from tax, and such expenditure would be allowed as business expenditure. To put it differently, such expenditure would then be considered as incurred in respect of other income which is to be treated as part of the total income.*

*33. There is no quarrel in assigning this meaning to section 14A of the Act. In fact, all the High Courts, whether it is the Delhi High Court on the one hand or the Punjab and Haryana High Court on the other hand, have agreed in providing this interpretation to section 14A of the Act. The entire dispute is as to what interpretation is to be given to the words 'in relation to' in the given scenario, viz. where the dividend income on the shares is earned, though the dominant purpose for subscribing in those shares of the investee company was not to earn dividend. We have two scenarios in these sets of appeals. In one group of cases the main purpose for investing in shares was to gain control over the investee company. Other cases are those where the shares of investee company were held by the assessees as stock-in-trade (i.e. as a business activity) and not as investment to earn dividends. In this context, it is to be examined as to whether the expenditure was incurred, in respective scenarios, in relation to the dividend income or not.*

*34. Having clarified the aforesaid position, the first and foremost issue that falls for consideration is as to whether the dominant purpose test, which is pressed into service by the assessees would apply while interpreting Section 14A of the Act or we have to go by the theory of apportionment. We are of the opinion that the dominant purpose for which the investment into shares is made by an assessee may not be relevant. No doubt, the assessee like Maxopp Investment Limited may have made the investment in order to gain control of the investee company. However, that does not appear to be a relevant factor in determining the issue at hand. Fact remains that such dividend income is non-taxable.*

*In this scenario, if expenditure is incurred on earning the dividend income, that much of the expenditure which is attributable to the dividend income has to be disallowed and cannot be treated as business expenditure. Keeping this objective behind Section14A of the Act in mind, the said provision has to be interpreted, particularly, the word 'in relation to the income' that does not form part of total income. Considered in this hue, the principle of apportionment of expenses comes into play as that is the principle which is engrained in Section 14A of the Act. This is so held in Walfort Share and Stock Brokers P Ltd., relevant passage whereof is already reproduced above, for the sake of continuity of discussion, we would like to quote the following few lines therefrom.*

> *The next phrase is, "in relation to income which does not form part of total income under the Act". It means that if an income does not form part of total income, then the related expenditure is outside the ambit of the applicability of section 14A..*
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> *xxx xxx xxx*
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> *The theory of apportionment of expenditure between taxable and non-taxable has, in principle, been now widened under section 14 A.*

*35. The Delhi High Court, therefore, correctly observed that prior to introduction of Section 14A of the Act, the law was that when an assessee had a composite and indivisible business which had elements of both taxable and non-taxable income, the entire expenditure in respect of said business was deductible and, in such a case, the principle of apportionment of the expenditure relating to the non-taxable income did not apply. The principle of apportionment was made available only where the business was divisible. It is to find a cure to the aforesaid problem that the Legislature has not only inserted Section 14A by the Finance (Amendment) Act, 2001 but also made it retrospective, i.e., 1962 when the Income Tax Act itself came into force. The aforesaid intent was expressed loudly and clearly in the Memorandum explaining the provisions of the Finance Bill, 2001. We, thus, agree with the view taken by the Delhi High Court, and are not inclined to accept the opinion of Punjab & Haryana High Court which went by dominant purpose theory. The aforesaid reasoning would be applicable in cases where shares are held as investment in the investee company, may be for the purpose of having controlling interest therein. On that reasoning, appeals of Maxopp Investment Limited as well as similar cases where shares were purchased by the assessees to have controlling interest in the investee companies have to fail and are, therefore, dismissed.*

Therefore, the fact remains that the dividend income from the two companies is not taxable and in that scenario the expenditure incurred on interest paid on funds borrowed in respect of investment in shares oftwo operating companies is hit by Section 14A of the Act inasmuch as the dividend received on such shares does not form part of the total income.

9 In the circumstances, we do not find any infirmity in the findings arrived at by the ITAT, the question of law is answered in affirmative.

10 Appeal dismissed.

**(DR. NEELA GOKHALE, J.)** **(K. R. SHRIRAM, J.)**