
(2015) 02 MAD CK 0339

In the Madras High Court

Case No : T.C.A. Nos. 1174 and 1175 of 2007

Patco Investment and Consultancy Services P. Ltd.

APPELLANT

Vs

Assistant Commissioner of Income Tax

RESPONDENT

Date of Decision : 02-02-2015

Acts Referred:

Finance Act, 2001 — Section 94(7)

Income Tax Act, 1961 — Section 10(33), 14, 142(1), 143(1), 14A

Citation : (2015) 372 ITR 195 : (2015) 233 TAXMAN 110

Hon'ble Judges : R. Sudhakar, J;R. Karuppiiah, J

Bench : Division Bench

Advocate : J. Balachander, for the Appellant; A.P. Srinivas, Advocates for the Respondent

Judgement

R. Sudhakar, J.—Aggrieved by the order of the Tribunal in dismissing the appeal filed by it, the assessee is before this court by filing the present appeal. This court, vide order dated September 24, 2007, while admitting the appeal, framed the following substantial questions of law for consideration :

"(1) Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the business loss incurred in the course of purchase and sale of mutual fund units is an expenditure incurred for earning exempt dividend income and, hence, not allowable under section 14A of the Income-tax Act, 1961 ignoring the fact that the dividend income preceded the occurrence of loss? and

(2) Whether, on the facts and in the circumstances of the case, the Tribunal was right in holding that the transaction of purchase and sale of units had not taken place without appreciating the evidence produced and after holding that the loss on sale of shares is an expenditure for earning dividend income?"

The appellant-assessee is engaged in the business of trading in stocks and shares. The appellant-assessee, for the assessment year 2001-02, filed its return

of income on October 22, 2001, declaring a loss of Rs. 43,67,910. The return was processed under section 143(1) of the Income-tax Act (for short "the Act") on October 17, 2002. Notice under section 142(1) was issued calling for certain information and the same was furnished. In the return, the assessee claimed dividend of Rs. 98,47,325 as exempt under section 10(33) of the Act. The assessee received dividends from various companies on mutual fund units. The dividend includes dividend of Rs. 40,22,988 received from Sun F and C Mutual Fund units and dividend of Rs. 58,06,451 received from J.M. Mutual Fund units along with other dividends, which were claimed to be exempt under section 10(33) of the Act. Notice was issued on the assessee and in response to the said notice, particulars sought for were provided by the assessee. From the narration of details as culled out by the Assessing Officer, it appears that the following transaction took place, as could be seen from the assessment order and for better clarity, the said portion of the assessment order is extracted hereinbelow :

"The assessee claims to have accepted a loan of Rs. 2 crores from M/s. Kotak Mahindra Finance Ltd., vide agreement dated December 14, 2000. The assessee filed a copy of the said loan agreement. The agreement is undated and is signed by the assessee only. The assessee also executed a power of attorney in favour of M/s. Kotak Mahindra Finance Ltd., enabling the latter to bid/apply or subscribe mutual fund units, to pay monies due on bid/application, to make application for redemption, to receive dividend, to receive consideration consequent on sale.

Record date for distribution of dividend in the case of Sun F and C Mutual Fund was December 18, 2000. M/s. Kotak Mahindra Finance Ltd., purchased 11,49,425 units of Sun F and C Mutual Fund on December 18, 2000, at Rs. 17.40 for a total consideration of Rs. 2 crores. M/s. Kotak Mahindra Finance Ltd. directly paid the purchase consideration to the mutual fund. Thus, M/s. Kotak Mahindra Finance Ltd. purchased the units-cum-dividend price of Rs. 17.40. On the record date, dividend at Rs. 3.50 per unit amounting to Rs. 40,22,988 was to be received by M/s. Kotak Mahindra Finance Ltd. The units were purchased with the dividend reinvestment option, hence the dividend of Rs. 40,22,988 was reinvested at Rs. 13.60 per unit equivalent to 295,807 units. Immediately one day after the record date on December 19, 2000, all the units were redeemed at Rs. 13.44 per unit. On redemption M/s. Kotak Mahindra Finance Ltd., received Rs. 1,54,00,947 (excluding dividend) directly from the mutual fund. Thus, the mutual fund units were purchased-cum-dividend at Rs. 17.40 and redeemed ex-dividend at Rs. 13.44. Thus, in the transaction M/s. Kotak Mahindra Finance Ltd. incurred loss of Rs. 3.96 per unit. This loss is claimed by the assessee as its trading loss. The assessee neither received cash of Rs. 2 crores nor the redemption amount of Rs. 1.54 crores, excluding dividend. Not the dividend of Rs. 40,22,988 was received by the assessee. The loan account with M/s. Kotak Mahindra Finance Ltd., was squared up by the assessee by paying the balance due. The assessee received an incentive of Rs. 2,70,000 from M/s. Kotak Securities for making the alleged investment. The assessee claims to have paid an interest of Rs. 28,110 towards the loan. The details of expenditure or loss claimed by the assessee is worked

out as under :

Expenditure/Loss claimed - Sun F and C Mutual Fund Units - Open dividend reinvested

Total expenditure incurred on purchase of 1445233.265 units

The total consideration realised on sale of these units

The assessee neither received cash of Rs. 2 crores nor the redemption amount of Rs. 1.54 crores excluding dividend. Nor the dividend of Rs. 40,22,988 was received by the assessee though the assessee was not involved in the transaction, it claimed to have received dividend of Rs. 40,22,988. The assessee also claimed the expenditure/loss of Rs. 43,57,163 as being part of its trading operations."

2. Accordingly, the claim of expenditure/loss in the purchase and sale of units was disallowed by the Assessing Officer. Against the said order, the assessee preferred an appeal to the Commissioner of Income-tax (Appeals), who dismissed the same confirming the order of the Assessing Officer, which on appeal to the Tribunal, was held against the assessee and, hence, the assessee-appellant is before this court by filing the present appeal.

3. Learned counsel appearing for the assessee points out that in respect of the assessment year in question, i.e., 2001-02, in the light of the new provisions as contained in section 94(7) of the Act, which was brought in by the Finance Act, 2001, with effect from April 1, 2002, the decision of the Supreme Court in the case of Commissioner of Income Tax, Mumbai Vs. Walfort Share and Stock Brokers P. Ltd., (2010) 233 CTR 42 : (2010) 8 SCC 137 : (2010) 1 SCR 801 , is squarely applicable. Learned counsel for the assessee relied on the abovesaid decision to contend that buying and selling of units resulting in inflow of dividends and at the same time business loss on sale of the units after the record date could not be equated to the transaction in terms of section 94(7) of the Act, which came into effect from April 1, 2002, since the assessment year pertaining to the present case is 2001-02. Per contra, the stand of the Department is that the transaction in the present case would fall under section 14A of the Act and, therefore, in view of the concurrent findings rendered by the authorities below, no interference is warranted with the impugned order.

4. Heard the learned counsel appearing for the appellant-assessee and the learned standing counsel appearing for the respondent-Department and also perused the documents available in the typed set of documents as also the judgment relied on by the learned counsel for the appellant-assessee.

5. The core issue that arises for consideration in the present appeal is "whether section 14A of the Act is invocable by the Department in the transaction in issue?"

6. Sub-section (7) of section 94 of the Income-tax Act was inserted, vide Finance

Act, 2001, with effect from April 1, 2002. For better clarity, sub-section (7) of section 94 of the Income-tax Act is extracted hereunder:

"94. (7) Where-

- (a) any person buys or acquires any securities or unit within a period of three months prior to the record date;
- (b) such person sells or transfers;
- (i) such securities within a period of three months after such date; or
- (ii) such unit within a period of nine months after such date;
- (c) the dividend or income on such securities or unit received or receivable by such person is exempt,

then, the loss, if any, arising to him on account of such purchase and sale of securities or unit, to the extent such loss does not exceed the amount of dividend or income received or receivable on such securities or unit, shall be ignored for the purposes of computing his income chargeable to tax."

7. From a reading of the above section, it is clear that sub-section (7) of section 94 was inserted to clarify the position as to how the computation of income to be made for the purpose of charging tax in the case of purchase and sale of securities or units within a specified period. The purport of insertion of sub-section (7) of section 94 is only to curb dividend stripping, which is used as a colourable device. The said section 94(7) having come into effect from April 1, 2002, the same will be enforceable only from the assessment year 2002-03 onwards. In the present case, the assessment year pertains to 2001-02. Therefore, it is clear that section 94(7) would not be applicable to the case on hand, as the said section itself has come into force only on April 1, 2002, i.e., and is not enforceable for the previous assessment year, viz., 2001-02.

8. In the above backdrop, it is brought to the notice of the court by the learned counsel for the appellant the decision of the Supreme Court in the case of Commissioner of Income Tax, Mumbai Vs. Walfort Share and Stock Brokers P. Ltd., (2010) 233 CTR 42 : (2010) 8 SCC 137 : (2010) 1 SCR 801 , wherein an identical issue fell for consideration. In the said case, the Supreme Court, while negating the stand of the Department that the transaction in the said case would fall under section 14A, distinguished the stand of the Department, in bringing the case under section 14A, holding that the loss in the sale of units could be disallowed on the ground that the impugned transaction was a transaction of dividend stripping and, therefore, it was alleged to be a colourable device. The Supreme Court, in the said decision, held as follows (page 15) :

"The main issue involved in this batch of cases is-whether in a dividend stripping transaction (alleged to be colourable device by the Department) the loss on sale of units could be considered as expenditure in relation to earning of dividend income exempt under section 10(33), disallowable under section 14A of the Act?

According to the Department, the differential amount between the purchase and sale price of the units constituted "expenditure incurred" by the assessee for earning tax-free income, hence, liable to be disallowed under section 14A. As a result of the dividend pay-out, according to the Department, the NAV of the mutual fund, which was Rs. 17.23 per unit on the record date, fell to Rs. 13.23 on March 27, 2000 (the next trading date) and, thus, Rs. 4 per unit, according to the Department, constituted "expenditure incurred" in terms of section 14A of the Act. In its return, the assessee, thus, claimed the dividend received as exempt under section 10(33) and also claimed set off for the loss against its taxable income, thereby seeking to reduce its tax liability and gain tax advantage.

The insertion of section 14A with retrospective effect is the serious attempt on the part of 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 November 22, 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 of 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. In section 14A, the first phrase is "for the purposes of computing the total income under this Chapter" which makes it clear that various heads of income as prescribed under Chapter IV would fall within section 14A. 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. Further, section 14 specifies five heads of income which are chargeable to tax. In order to be chargeable, an income has to be brought under one of the five heads. Sections 15 to 59 lay down the rules for computing income for the purpose of chargeability to tax under those heads. Sections 15 to 59 quantify the total

income chargeable to tax. The permissible deductions enumerated in sections 15 to 59 are now to be allowed only with reference to income which is brought under one of the above heads and is chargeable to tax. 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. The theory of apportionment of expenditure 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). Every pay-out is not entitled to allowances for deduction. These allowances are admissible to qualified deductions. These deductions are for debits in the real sense. A pay-back does not constitute an "expenditure incurred" in terms of section 14A. Even applying the principles of accountancy, a pay-back in the strict sense does not constitute an "expenditure" as it does not impact the profit and loss account. Pay-back or return of investment will impact the balance-sheet whereas a return on investment will impact the profit and loss account. The cost of acquisition of an asset impacts the balance-sheet. Return of investment brings down the cost. It will not increase the expenditure. Hence, expenditure, return on investment, return of investment and cost of acquisition are distinct concepts. Therefore, one needs to read the words "expenditure incurred" in section 14A in the context of the scheme of the Act and, if so read, it is clear that it disallows certain expenditure incurred to earn exempt income from being deducted from other income which is includible in the "total income" for the purpose of chargeability to tax. As stated above, the scheme of sections 30 to 37 is that profits and gains must be computed subject to certain allowances for deductions/expenditure. The charge is not on gross receipts, it is on profits and gains. Profits have to be computed after deducting losses and expenses incurred for business. A deduction for expenditure or loss which is not within the prohibition must be allowed if it is on the facts of the case a proper debit item to be charged against the incomings of the business in ascertaining the true profits. A return of investment or a pay-back is not such a debit item as explained above, hence, it is not "expenditure incurred" in terms of section 14A. Expenditure is a pay-out. It relates to disbursement. A pay-back is not an expenditure in the scheme of section 14A. For attracting section 14A, there has to be a proximate cause for disallowance, which is its relationship with the tax exempt income. Pay-back or a return of investment is not such proximate cause, hence, section 14A is not applicable in the present case. Thus, in the absence of such proximate cause for disallowance, section 14A cannot be invoked. In our view, a return of investment cannot be construed to mean "expenditure" and if it is construed to mean "expenditure" in the sense of physical spending still the expenditure was not such as could be claimed as an "allowance" against the profits of the relevant accounting year under sections 30 to 37 of the Act and, therefore, section 14A

cannot be invoked. Hence, the two asset theory is not applicable in this case as there is no expenditure incurred in terms of section 14A."

9. The Supreme Court, in the above decision, further fortified this issue by stating that such a transaction was curbed by the introduction of section 94(7) in the Finance Act, 2001, with effect from April 1, 2002, relevant to the assessment year 2002-03.

10. In view of the abovesaid decision of the Supreme Court, the plea of the Department that the transaction would attract section 14A of the Act fails and this court holds that the assessee is entitled to claim the amount as business loss during the assessment year in question. The substantial questions of law are answered accordingly. In the result, the appeals are allowed setting aside the order of the Tribunal. However, in the circumstances, there shall be no order as to costs.