Section 14A disallowance

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Introduction

Introduction

- Section (S.) 14A was inserted in the Income Tax Act (ITA) with retrospective effect from 1 April 1962 by the Finance Act 2001.

The extract of the current provision is as under

"Expenditure incurred in relation to income not includible in total income.

14A. (1) For the purposes of computing the total income under this Chapter, 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.*

(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 prescribed19, 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

Object of Section 14A

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- The object of inserting S. 14A is explained in the Explanatory Memorandum to Finance Bill 2001 and CBDT Circular No. 14 dated 22 November 2001 explaining the amendments by Finance Act 2001 and they are as under:

Extracts from Memorandum explaining provisions of S. 14A in the Finance Bill 2001

"…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"

Object of section 14A

Extracts from Circular No.14 dated 22 November 2001 explaining amendments by Finance Act 2001 inserting S. 14A in the ITA.

"....No deduction for expenditure incurred in respect of exempt income against taxable income.

25.1 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. 25.2 Through Finance Act, 2001, a new section 14A has been inserted 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"

Object of section 14A

The aforementioned object of section 14A was also explained and followed in the below mentioned judicial precedents:

- CIT vs Walfort Share & Stock Brokers (P) Ltd (2010) 326 ITR 1 (SC)
- Godrej & Boyce Mfg. Co. Ltd. v. DCIT (2010) 328 ITR 81 (Bom)
- CIT v. Catholic Syrian Bank & Others (2011) 49 DTR 57 (Ker)
- Maxopp Investment Ltd. v. CIT (2011) 64 DTR 122 (Del)
- Dhanuka & Sons v. CIT (2011) 54 DTR 345 (Cal)

Scope of section 14A

Scope of S. 14A – 'in relation to'

S. 14A employs the phrase **'in relation to'** to qualify the expenditure which can be disallowed under this section. In other words, the expenditure which can be disallowed is one which has relation to exempt income.

View 1

Whether 'in relation to' conveys **a direct or proximate nexus** between expenditure and exempt income and thus, only direct expenditure can be disallowed under S. 14A?

View 2

Whether 'in relation to' needs to be construed **broadly and hence any expenditure which has direct or indirect nexus** with the exempt income can be disallowed under S. 14A?

Scope of S. 14A – 'in relation to'

View 1 –

In relation to' conveys **a direct or proximate nexus** between expenditure and exempt income and thus, only direct expenditure can be disallowed under S. 14A. Reliance in this regard can be placed on the following judicial precedents:

- CIT vs Walfort Share & Stock Brokers (P) Ltd (2010) 326 ITR 1 (SC)
- Godrej & Boyce Mfg. Co. Ltd. v. DCIT (2010) 328 ITR 81 (Bom)
- Wimco Seedlings Ltd v. DCIT (2007) 107 ITD 267 (Del)
- ACIT v. Eicher Ltd. (2006) 101 TTJ 369 (Del)
- Yatish Trading Co. (P) Ltd. v. ACIT (2011) 129 ITD 237 (Mum)

Scope of S. 14A – 'in relation to'

View 2

In relation to needs to be construed broadly and hence any expenditure which has direct or indirect nexus with the exempt income can be disallowed under S. 14A. Reliance in this regard can be placed on the following judicial precedents:

- Maruti Udyog Ltd. v. DCIT (2005) 92 ITD 119 (Del)
- Escorts Ltd v. ACIT (2007) (104 ITD 427) (Del)
- DCIT v. S.G. Investments & Industries Ltd. (2004) 89 ITD 44 (Cal)
- ACIT v. Citicorp Finance (India) Ltd (2007) 108 ITD 457 (Mum)
- Conwood Agencies (P) Ltd v. ITO (2007) 15 SOT 308 (Mum)

Whether notional or assumed expenditure can be disallowed under S. 14A?

Can notional expenditure be disallowed?

The Courts are unanimous in their view that S. 14A does not authorize disallowance of notional or assumed expenditure. Disallowance can be made only with respect to actual expenditure. This proposition is supported by the following illustrative judicial precedents

- Maxopp Investment Ltd. v. CIT (2011) 64 DTR 122 (Del)
- CIT v. Printers House (P.) Ltd (2010) 188 Taxman 70 (Del) (SLP dismissed by SC vide SLP(C) no. 4359 of 2010)
- CIT v. Hero Cycles Ltd (2010) 323 ITR 518 (P&H)
- Wimco Seedlings Ltd v. DCIT (2007) 107 ITD 267 (Del)
- Millennium Infocom Technologies Ltd v. ACIT (2009) (117 ITD 114) (Del)

Whether onus of establishing nexus between expenditure and exempt income is on the taxpayer or on the A.O?

Onus of establishing

For the periods prior to insertion of procedural provisions of S. 14A(2)/(3), there was conflict of views on the issue whether the onus to prove that expenditure is incurred in relation to exempt income is on the taxpayer or the AO.

In the following cases, it was held that the burden was on the AO to prove that

expenditure was incurred in relation to exempt income and if the AO fails to

discharge such onus, no disallowance could be made under S. 14A:

- Maruti Udyog ruling (supra)

Onus of establishing

In the following cases, it was held that the burden was on the Taxpayer to prove that no expenditure is incurred in relation to exempt income:

- Haryana Land Reclamation & Development Corporation Ltd v. CIT (2008) 302 ITR 218 (P&H)

- ITO v. Daga Capital Management (P) Ltd (2008) (26 SOT 603) (SB)

Onus of establishing

For the periods after the insertion of procedural provisions of S. 14A(2)/(3) and Rule 8D, it has been held that the AO should first determine whether he is satisfied with the quantification of disallowance by the taxpayer. Only if he is not satisfied with the taxpayer's computation does he acquire jurisdiction to invoke Rule 8D. Further, before invoking Rule 8D the tax Authority has to record reasons for his dissatisfaction and provide opportunity to the taxpayer. Reliance in this regard can be placed on the following judicial precedents;

- Godrej & Boyce ruling (supra)
- Maxopp ruling (supra)
- DCIT v. Jindal Photo Ltd. (ITA No. 4539/Del/2010)

Can 14A disallowance be made if there is no exempt income?

No exempt income – No disallowance

Consistent with the object of S. 14A which is that expenditure incurred in relation to exempt income cannot be allowed as deduction, it is fairly arguable that if expenditure is not incurred in relation to exempt income, it cannot be disallowed by virtue of S. 14A.

This is supported by the following clarifications in the Explanatory Memorandum and CBDT Circular No.14 referred earlier:

"Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income."

This principle is also supported by the following ITAT decisions:

- JCIT v. Holland Equipment Co. B.V (2005) 3 SOT 810 (Mum)
- ITO v. Rhino Bags (P) Ltd (2007) 12 SOT 571 (Mum)

Recently Madras High Court in the case of M/s.Redington (India) Ltd Vs The Additional Commissioner of Income-tax (TCA No 520 of 2016) has upheld that the AO cannot invoke section 14A of the Income Tax Act read with Rule 8D of the Income Tax Rules when the assessee does not derived exempted income during the relevant assessment year

Can section 14A disallowance be made if no expenditure is incurred?

No expenditure – No Disallowance

In the following judicial precedents, it has been held that no disallowance under section 14A of the Act can be made if the assessee has not incurred any expenditure for earning the exempt income:

- Hero Cycles Limited [(2010) 189 taxman 50]
- Metalman Auto Private Ltd. [(2011) 11 taxman 51]
- Winsome Textile Industries Ltd. [(2009) 319 ITR 204]
- Wimco Seedlings Ltd. vs DCIT [(2007) 107 ITD 267]
- Justice Sam P Bharucha vs ACIT, Mumbai [(2012) 25 taxmann.com 381 ((Mum.)]
- Bayer Bio Science (P) Ltd. vs ACIT [(2012) 20 taxmann.com 79]
- DCIT vs Allied Investments Housing Private Limited [(2013) ITA no. 305/Mds/2013]

Can S. 14A be invoked by the ITAT for the first time?

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In the case of **Topstar Mercantile (P) Ltd. v. ACIT (2011) 334 ITR 374 (Bom)**, the AO had made certain queries regarding S. 14A in the course of assessment proceedings. Satisfied by Taxpayer's explanation, AO had not pursued the matter further. The Taxpayer filed appeal before CIT(A) on other grounds including disallowance of interest for non-business purpose. The CIT(A) sustained the A.O's order.

The Taxpayer filed further appeal before the ITAT. The ITAT while restoring the matter back to AO applied ITO v. Daga Capital Management (P) Ltd (2008) (26 SOT 603) (SB) (A.Y. 2001-02) (Daga Capital SB ruling) and directed him to reconsider the issue on the touchstone of S. 14A.

On further appeal by taxpayer the HC accepted the Taxpayer's contention that since the AO had agreed on non-applicability of disallowance under S. 14A, the ITAT could not have touched this question to make observations prejudicial to the Taxpayer while remanding the matter. The ITAT's direction to the extent it directed consideration of S. 14A was quashed by the HC.

This decision was followed in ACIT v. Delite Enterprises (P) Ltd (2011) 128 ITD 146 (Mum)

Rule 8D

Rule 8D

Method for determining amount of expenditure in relation to income not includible in total income.

(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; and

(ii) an amount equal to **one per cent** of the annual average of the monthly average of the opening and closing balances of the value of investment, income from which does not or shall not form part of total income ;

Rule 8D

There has been a spate of disputes on the application of this Rule. In order to rationalise the formula in Rule 8D, and to give effect to the FM's promise while presenting the Budget speech 2016, a new Rule 8D providing for a revised method for determining the amount of disallowance of expenditure on earning exempt income has been notified by CBDT. The key comparison and summary of this new Rule with the Old Rule is as under:

S.No	Old Rule	New Rule	Impact of change
1	Expenditure directly incurred to earn exempt income [Rule 8D(2)(i)]	Expenditure directly incurred to earn exempt income [Rule 8D(2)(i)]	No change
2	The interest expense worked out on the basis of a prescribed formula (in the proportion of average value of investments yielding exempt income, to average value of total asset) which is not directly attributable to any exempt income [Rule 8D(2)(ii)]	No such provision	The formula specified in relation to indirect interest expenditure has been deleted. Accordingly, indirect interest expenses will not be disallowed.

Rule 8D

S.No	Old Rule	New Rule	Impact of change
3	On presumptive basis, i.e. 0.5% of the annual average value of investments yielding exempt income [Rule 8D(2)(iii)]	On presumptive basis, i.e. 1% of the annual average of the monthly averages of value of investments yielding exempt income [Rule 8D(2)(ii)]	A) Change in rate of presumptive expenditure has been increased to 1% from 0.5%. B) The existing rule prescribes considering the annual average value of investment, whereas the new rule provides for the annual average of the monthly averages of value of investments.
4	No such provision	The disallowance amount as computed under Rule 8D shall not exceed total expenditure claimed by the taxpayer. [Proviso to Rule 8D(2)]	The new rule provides for upper limit cap on disallowance at total expenditure claimed by taxpayer.

Rule 8D

While computing the disallowance under Rule 8D, care should be taken to see that the amounts considered under all the limbs are tax admissible amounts of such expenses and not the amount which are debited in the Profit & Loss A/c.

For e.g. A part of the interest expenditure payable to financial institution or banks may be disallowable under S.43B such expenditure should not be considered while computing under Rule 8D to avoid double disallowance of the same expenditure.

Whether ‘Investments’ as referred in Rule 8D will also include stock-in-trade?

Investments include stock-in-trade?

View 1 – The term 'investments' used in third limb of Rule 8D does not cover stock-in-trade

The term 'investments' is not defined in S. 14A or Rule 8D. Hence reference can be made to ordinary commercial meaning thereof.

Accounting Standard 13 of ICAI - Accounting for Investments

Investments are assets held by an enterprise for earning income by way of dividends, interest, and rentals, for capital appreciation, or for other benefits to the investing enterprise. **Assets held as stock-in-trade are not 'investments'**. (Para 3)

Guidance note on terms used in Financial Statement

Assets held not for operational purpose or for rendering services i.e. assets other than fixed assets or current asset (e.g. Securities, shares, debentures, immovable properties). (Para 8.10)

Investments include stock-in-trade?

Macnaghten J. in IRC v. Rolls-Royce Ltd. (No. 2) (1944) 29 Tax Cases 137 (KB)

"The word 'investment', though it primarily means the act of investing, is in common use as meaning that which is thereby acquired; and the primary meaning of the transitive verb 'to invest' is to lay out money in the acquisition of some species of property……"

Rule 8D refers to investments as are appearing in the balance sheet of a taxpayer. Thus, only those items which are reflected in the balance sheet as investments need alone be taken into account while applying the formula.

Investments include stock-in-trade?

View 2 – The term 'investments' used in third limb of Rule 8D cover stock-in-trade

The text of main section does not refer to the expression "investment".

The intent is to cover each source of exempt income. It does not make any distinction between exempt income arising from shares held as investment v. shares held as stock-in-trade.

The methodology provided in a Rule cannot abridge the scope of the main provision.

Reliance in this regard can be placed on the following judicial precedents:

- ITO v. Daga Capital Management (P) Ltd (2008) (26 SOT 603) (SB)
- Maxopp Investment Ltd. v. CIT (2011) 64 DTR 122 (Del)

Whether strategic investment in subsidiaries not covered for Section 14A disallowance?

Strategic investment in subsidiaries

It has been held in the following judicial precedents if investments in subsidiaries & joint ventures is for strategic purposes and not for intention of earning dividend, there will not be 14A disallowance;

- U P Electronics Corporation Limited vs Deputy Commissioner of Income Tax (ITA No. 538/LKW/2012)
- L&T Infrastructure Development Projects Limited vs ITO (ITA No. 2226/ Mds/ 2013)
- ACIT vs M/s Oriental Structural Engineers P Ltd (ITA No. 4245/Del/ 2011)
- Interglobe Enterprises Lts vs DCIT
- MSA Security Services Pvt. Ltd vs ACIT(ITA No. 1523/Mds.2012)

Whether ‘investments’ are to be taken at gross or net of provisions for diminution in value of asset

Investment value to be considered gross or net value

Investment to include only net value

- Since Rule 8D is an artificial formula for computing disallowance, it needs to be construed strictly.
- The reference is **not to cost of investment but to 'value of investment'** which cannot be equated with gross book value of the investment.
- Reference may be made to SC decision in the case of Vijaya Bank v. CIT (2010) 323 ITR 166 (SC) where it was held that a provision which is debited to P&L A/c and reduced from corresponding amount of loans and advances/debtors on the assets of the balance sheet **constitutes an actual write off**.

Whether S.14A applies to ‘allowance’ in the nature of depreciation on assets?

Whether S.14A applies to 'allowance' in the nature of depreciation on assets?

For the purpose of this question, it is assumed that depreciation relates to asset which is directly used for the purposes of earning exempt income. For example, it can cover a situation where depreciation is claimed in respect of computer or similar assets which are used by employees who work as investment analyst exclusively. It can cover depreciation on car which is provided as perquisite to such employee who is devoted to the investment division of the company and there is no dispute on the proposition that investment activity is within the radar of S.14A.

Whether S.14A applies to 'allowance' in the nature of depreciation on assets?

- S. 14A specifies that no deduction shall be allowed in respect of 'expenditure' incurred by the assessee in relation to income which does not form part of total income.
- The section clearly refers to 'expenditure' and not an 'allowance'. It is well settled that depreciation is an 'allowance' and not an expenditure.
- Reference to language of Rule 8D also supports that disallowance under S. 14A is restricted to 'expenditure' and does not extend to other deductions.
- In the following cases, it was held that there is a distinction between 'allowance' and 'expenditure' and hence, disallowance under S. 14A is restricted to 'expenditure' incurred in relation to exempt income and it cannot be extended to allowance by way of depreciation.
  - Vishnu Anant Mahajan v. ACIT (TS-396 ITAT-2012) (Ahd) (SB)
  - D. Nanavati v. ACIT (2011 INDLAW ITAT 19) (Mum)

Whether computational provisions of S. 14A read with Rule 8D can be applied for computing book profit under S. 115JB?

MAT and Section 14A

The computation of 'book profit' under S. 115JB requires addition of amount of expenditure relatable to any income to which S. 10 (other than S. 10(38)) or S. 11 or S. 12 apply if such amount is debited to P&L A/c and reduction of amount of income to which any of the aforesaid provisions apply if such amount is credited to P&L A/c. In other words, like in case of computation of income under normal provisions, book profit computation also envisages exclusion of exempt income and disallowance of related expenditure.

Issue, therefore, arises whether the computation provisions of S. 14A read with Rule 8D can be applied to book profit computation while computing the amount of expenditure to be added back?

MAT and Section 14A

- The phrase 'For the purposes of computing the total income under this Chapter' makes it clear that S. 14A can be applied only to Chapter IV under which S. 14A falls (i.e. S. 14 to S. 59). It cannot be extended to any other provisions of the ITA including S. 115JB either in terms of its express language or by way of analogy.
- Reliance in this regard can be placed on the following CBDT Circular/judicial precedents wherein it has been held that manner of computation of book profit (including addition of expenditure relatable to exempt income) is governed only by S.115JB(2) :
  - CBDT Circular no. 13 of 2001 dated 9 November 2001
  - Goetze (India) Ltd. v. CIT (2009) 32 SOT 101 (Del)
  - Quippo Telecom Infrastructure Ltd. v. ACIT (ITA no. 4931/Del/2010)
  - Essar Teleholdings Ltd v. DCIT (ITA no. 3850/Mum/2010)
  - M/s National Commodity & Derivatives Exchange Ltd., (ITA no.2923/Mum/2010)
  - ACIT v. J K Paper Ltd. (ITA no. 979/Ahd/2006) & DCIT v. J K Paper Ltd. (ITA no. 4027 and 4080/Ahd/2008)).

Applicability of S. 14A to income earned by partner from partnership firm

Applicability of S. 14A to income earned by partner from partnership firm

In the following cases, the ITAT accepted the argument of the taxpayer that share of profit **merely represents income which has already suffered tax in the hands of the firm** and since the firm is **legally not a separate juristic person** but merely considered as assessable entity for tax purposes, the share of profit retains the same character as in the hands of the firm. Hence, although share of profit is exempt under S. 10(2A), provisions of S. 14A do not apply to it and any expenditure incurred by the partner in earning share of profit and which is not allowed as deduction in hands of the firm is allowable as deduction in the hands of the partner.

- Sudhir Kapadia v. ITO (ITA No. 7888/M/03)
- ACIT v. Rustom J. Gagrat (ITA No. 3860/M/00)
- Shri Bharat S. Raut (ITA No. 9212/M/2004)
- Hitesh D. Gajaria v. ACIT (ITA No. 993/M/2007)

Applicability of S. 14A to income earned by partner from partnership firm

In the following cases, it has been held that since share of profit is exempt under S. 10(2A), no expenditure can be allowed as deduction against such income.

- A. H. Baldota v. ACIT (2006) 10 SOT 757 (Mum)
- Sudhir Dattaram Patil v. DCIT (2005) 2 SOT 678 (Mum)
- D. J. Mehta v. ITO (2007) 104 ITD 527 (Mum)
- Marezban Bharucha v. ACIT (2007) 12 SOT 133 (Mum)
- CIT v. Popular Vehicles and Services Ltd. (2010) (325 ITR 523)

In view of conflict of ITAT rulings, the issue was referred to SB in the case Vishnu Anant Mahajan v. ACIT (TS-396-ITAT-2012) (Ahd) (SB). The SB held that S.14A is applicable to exempt share of profit since the partnership firm is a separate assessable entity under the ITA though, under general law, it does not have a separate legal existence. Hence, share of profit received from the firm cannot be regarded as tax paid income in the hands of a partner merely because the firm has paid tax on such income in its own assessment.

Penalty on account of S. 14A disallowance

Penalty on account of S. 14A disallowance

- S. 14A is a provision which has given rise to controversy on several issues resulting in multiple judicial precedents interpreting the provisions in varied ways.

- In the midst of conflicting judicial precedents on each and every issue, it is fairly arguable that a taxpayer putting up a claim on the basis of a bonafide view supported by any judicial precedent and/or a professional's opinion with appropriate disclosure of facts cannot be visited with penalty proceedings for concealment of income and/or furnishing inaccurate particulars of income.

S. 263 revision vis-à-vis S. 14A disallowance

S. 263 revision vis-à-vis S. 14A disallowance

- S. 263 provides power to CIT to direct revision of assessment in case of an error committed by the Tax Authority which is prejudicial to the interests of the Revenue.
- It is well settled that this provision does not provide jurisdiction to the CIT where the issue is debatable and the Tax Authority has adopted one of the possible views of the matter.
- In the following two cases, the initiation of revision proceedings were upheld for the reason that the Tax Authority had not considered the applicability of S. 14A at all in the assessment proceedings.
  - CIT v. Galileo India Pvt. Ltd. (ITA No. 1074/2011) (Del)
  - Jammu & Kashmir Bank Ltd. v. ACIT (2009) (118 ITD 146)

Thanks

CA Raamanathan K