Disallowance u/s 14A with reference to a dealer of shares and securities

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Right from its inception, the scope of section 14A of the Income Tax Act, 1961 has been a subject matter of controversies and litigation between the tax payers and the tax collectors. One of the issues, surrounding disallowance u/s. 14A, is the possibility of disallowance of an expenditure in the hands of a dealer of shares and securities, who holds such shares and securities as stock-in-trade.

A dealer in shares and securities primarily receives two streams of income:-

- income from transfer of shares which is taxable under the head 'Profits and gains of business or profession' and
- dividend income which is exempt from taxation u/s 10(34) of the Act.

The expenditure incurred by such a dealer dealing in shares and securities, like any other business, is of varied nature comprising of interest, administration expenses, depreciation etc.

The provisions of Section 14A provide that the assessee shall not be entitled to any deduction of expenditure incurred in relation to an income which does not form part of the total income. The section is founded on a valid rationale that the basic principle of taxation is to tax net income i.e. gross income (-) expenditure pertaining to such taxable income. The Memorandum to the Finance Bill 2001, explaining the legislative intent behind introduction of Section 14A clarifies that:-
"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".

Thus, it is important to analyze whether any portion of the expenditure incurred by a dealer of shares and securities be brought within the ambit of Section 14A and be said to have been incurred in relation to earning the exempt dividend income. The various views in respect of this is discussed as hereunder in the light of the prevailing judicial pronouncements:-

View 1:-

The activity of purchase and sale of securities by the dealer for business purposes, involve overhead costs and, further the retention of such securities, entail a holding cost. However, both the activities constitute an integral activity of purchase and holding of shares, although it generates two separate streams of income. Accordingly, the direct expenditure would be set off against the relevant income whereas all the indirect expenditure so incurred would be required to be apportioned between taxable and non-taxable incomes. A similar view has been held by the **Hon'ble Bombay High Court in the case of *Godrej & Boyce Mfg. Co. Ltd.* [2010] 328 ITR 81** and the **Mumbai Bench of the ITAT in the case of DCIT vs. Damani Estates and Finance (P) Ltd**. **[2014] 44 taxmann.com 385.**

The Court in the case of ***Godrej & Boyce Mfg. Co. Ltd.*** had after examining the genesis of the provision of section 14A, held that "*even in the case of 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 the income which forms part of the total income can be allowed. The expenditure incurred in relation to the income which does not form part of the total income has to be disallowed. Further, from this it would follow that Section 14A has within it implicit notion of apportionment".*

View 2:-

Rule 8D(2) prescribes the method for determination of the expenditure in relation to exempt income. The aggregate of the following amounts shall be disallowed:-

a. *the amount of expenditure directly relating to income which does not form part of total income;*
b. *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 by multiplying the common interest by the average value of investments, income from which does not or shall not form part of the total income and as is divided by the average value of assets appearing in the balance sheet of the assessee, on the first day and the last day of the previous year*
c. *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.*

Where the shares are held by the dealer as stock-in trade the provisions of Rule 8D(2)(ii) and (iii) shall not be applicable as it applies only to such situations wherein the shares are held as investments. One of the variables on the basis of which disallowance under rules 8D(2)(ii) and (iii) is to be computed, is the value of *"investments, income from which does not or shall not form part of total income"*, and, when there are no such investments, the rule cannot have any application. This language supports the case that no disallowance is envisaged in respect of shares held as stock in trade. Thus, where no amount can be computed in the light of the formula given in Rule 8D(ii) and (iii), no disallowance can be made under Rule 8D (2)(ii) and (iii).

It was further clarified that rule 8D(2)(i) which refers to the 'amount of expenditure directly relating to income which does not form part of total income' shall continue to be applicable. In other words, in a case where shares are held as stock-in-trade and not as investments, disallowance under rule 8D shall be restricted solely to the **expenditure directly relatable to earning of exempt income.** A similar view has been held by the Kolkata bench of the Tribunal in the case of **DCIT vs. Gulshan Investments Co. Ltd. [2013] 31 taxmann.com 113**.

View III

Section 14A contemplates the disallowance of expenditure incurred in relation to exempt income. The assessee being a dealer of shares holds such securities as stock in trade and does not retain them for the purposes of earning dividends. Such income is merely incidental to the asseseee's core business of dealing in shares and securities. Accordingly, no portion of the expenditure incurred by the assessee can be said to be attributable to earning such dividend income.

A similar view has been held by **the Karnataka High Court in the case of CCI Ltd vs. JCIT reported in 250 CTR 291** wherein it was stated that *"When no expenditure is incurred by the assessee in earning the dividend income, no notional expenditure could be deducted from the said income. When the assessee has not retained shares with the intention of earning dividend income and the dividend income is incidental to its business of sale of shares, which remained unsold by the assessee, it cannot be said that the expenditure incurred in acquiring the shares has to be apportioned to the extent of dividend income and that should be disallowed from deductions. In that view of the matter, the approach of the authorities is not in conformity with the statutory provisions contained under the Act. Therefore, the impugned orders are not sustainable and require to be set aside".*

Further, for a dealer in shares, the dominant or the immediate objective is making profit on sale of shares. Earning dividend income cannot be regarded as the dominant objective and the dividend shall represent an incidental objective. Thus, unless it is held that earning dividend is also a dominant objective and there is a proximate link with such objective, the expenditure in question cannot be considered as having been incurred in relation to the exempt dividend income.