Controversies surrounding Section 14A of the Income Tax Act

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Background and Rationale for introduction

Section 14A introduced by the Finance Act 2001 with retrospective effect from 1st April 1962 has been one of the most litigated provisions with different courts interpreting it differently. The Section provides for disallowance of such **expenditure which is *incurred in relation to income which does not form part of the total income***.

Prior to the introduction of Section 14A, the allowability of expenditure incurred in relation to exempt income was determined on the basis of interdependence of various activities *carried on by the assessee which yielded taxable and non-taxable income i.e. whether the activities constituted one single integrated activity or did they represent distinct businesses*. The Supreme Court on various occasions upheld that where an assessee had a composite and indivisible business and the income derived therefrom included both taxable and non-taxable income, the assessee shall be allowed a deduction of the entire expenditure including the expenditure incurred for earning non-taxable/ exempt income. However, in case the business was divisible, then the principle of apportionment of expenditure would apply and expenditure incurred in relation to the exempt income would be disallowed. [Refer: - Waterfall Estates Ltd. vs. CIT **[1996] 85 Taxman 689 (SC),** Rajasthan State Warehousing Corporation vs. CIT [2000] 109 Taxmann 145 (SC)].

The Revenue Authorities, however, perceived that such an interpretation by the various Courts resulted in misuse of the tax incentives given by way of exemptions to various categories of income, since it was being used to reduce the tax payable on the taxable income also, by debiting expenses incurred to earn exempt income against such taxable income. Accordingly, Section 14A was inserted in the statute book and has within it implicit notion of apportionment even in the cases where the expenditure is incurred for composite/ indivisible business wherein taxable and non- taxable income is received.

Nexus of expenditure with exempt income

The provisions of Section 14A provides for disallowance of **expenditure which is *incurred in*** relation to income which does not form part of the total income. The usage of the expression 'in relation to' in preference over 'directly relatable to' or 'wholly and exclusively for the purposes of', signifies that the legislature intends to give a wider meaning and include not only the direct expenditure but also the indirect expenditure in relation to the exempt income for the purposes of disallowance under section 14A. [Refer Maxopp Investment Ltd v CIT 203 Taxman 364 (Del)]

Section 14A is applicable only in respect of the "expenditure incurred" in respect of income which is not includible in the total income and does not deal with the losses. The term expenditure implies volition and relates to disbursements towards some obligation. However, loss is incidental to the carrying on of a business. In assessing the amount of profits and gains of a year, account must necessarily be taken of all losses incurred besides the expenditure allowable under sections 30 to 44D. Therefore, loss cannot be construed to be expenditure. [Refer CIT v Walfort Share and Stock Brokers (P) Ltd 192 Taxman 211 (SC)]. 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. [Refer Navin Bharat Industries Ltd. Vs. DCIT [2004] 90 ITD 1 (ITAT Mum)].

Applicability where income has suffered economic taxation

Another important question which is often raised and will be litigated in times to come is whether Section 14A will have application when income has suffered economic taxation, for e.g. dividend which is subjected to Dividend Distribution Tax. In the case of Godrej and Boyce Mfg Co. Ltd v DCIT 328 ITR 81 (Bom), it was held in favour of the Revenue that tax is not paid on behalf of shareholder but is paid in respect of payer's own liability. However, one wonders whether the amendment in Finance (No. 2) Act, 2014 in Section 115-O will be of any help. It is now provided that the amount of distributable profits shall be increased to such amounts as would after deduction of tax at the rate of 15% (excl. cess and surcharge) be equal to the net distributable profits. DDT is tax payable on distributable profits over and above the tax paid by the company on its profits. The Finance Minister in his Budget Speech stated that -

"In the year 2003, the tax liability on income by way of dividends was shifted from the

shareholder to the company. The shareholder was required to pay tax on the gross dividends, but now the company pays tax on the dividend amount net of taxes. Similarly, in the case of Mutual Fund, income distribution tax is paid on the income distributed net of taxes. I propose to remove this anomaly both in the case of the company and the Mutual Fund". Considering the introduction of the provisions of grossing up of dividends and the fact that the Finance Minister himself acknowledges that DDT is tax paid by the company on behalf of the shareholders, the basis on which the judgement supra was rendered falls through. A plausible argument may be made by the assessee that no disallowance can be made u/s 14A in respect of expenditure incurred for earning dividends since the same has suffered tax by levy of DDT.

Mechanical application of Rule 8D and the recent amendment

Rule 8D, inserted with effect from assessment year 2008-09, provides for the method of computation of disallowance under Section 14A. The insertion of this Rule has given rise to a large number of disputes particularly due to the AO mechanically applying the formula without regard to the facts of the case. The Finance Minister in his budget speech of 2016 acknowledged that the quantification of disallowance of expenditure relatable to exempt income in terms of Section 14A of the Income-tax Act has been the subject matter of disputes and had proposed to rationalize the formula in rule 8D governing such quantification. Accordingly, the said Rule has been amended by the CBDT vide Notification No. 43/2016 dated 2nd June, 2016 to provide that disallowance shall be the aggregate of directly relatable expenditure and 1% of the annual average of the monthly averages of the opening and closing balance of investments yielding income which does not or shall not form part of total income. The total disallowance shall not, however, exceed the actual expenditure claimed, thus putting to rest disputes in this regard.

It may be noted that Rule 8D cannot be applied mechanically by the AO. In the case of *Maxopp Investment Ltd. supra* Hon'ble Delhi High Court has held that "Rule 8D also makes it clear that where AO, having regard to the accounts of the assessee, is not satisfied with (a) 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 exempted income, shall determine the amount of the expenditure to such income in accordance with the provisions of sub-rule (2) of Rule 8D. Rule 8D(1) places the provisions of section 14A(2) and (3) in the correct perspective. It is therefore, clear that determination of amount of expenditure in relation to exempt income under rule 8D will be applicable if apart from objective criteria, AO gives a reasonable opportunity in order to satisfy himself about the correctness of assessee's claim. It has also been held that in case the

Assessing Officer is not satisfied then after giving assessee an opportunity may reject the claim after stating cogent reasons for doing so. It is well settled law that there can be no disallowance under section 14A on presumption only. If AO was not satisfied about the disallowance admitted by the AO, then it was his onus to prove that assessee's claim was wrong.

Application of Section 14A if the assessee has not earned any exempt income

The CBDT had vide Circular No. 5/ 2014 dated 11th February, 2014 clarified that the legislative intent is to allow only that expenditure which is relatable to earning of taxable income. It has laid emphasis on the usage of the term "includible" in the heading for the Section and Rule and stated that it indicates that exempt income need not necessarily be included in a particular year's income, for disallowance to be triggered.

However, there have been various judgements - Shivam Motors P Ltd (All HC), CIT vs. Corrtech Energy Pvt. Ltd (Guj HC), Cheminvest Ltd. vs. CIT [2015] 61 taxmann.com 118 (Delhi), CIT vs. Delite Enterprises (Bom HC), CIT vs. Lakhani Marketing (P&H HC), CIT vs. Winsome Textiles Industries Ltd 319 ITR 204 (P&H) – wherein it has been held that when there is no exempt income and no claim for exemption, s. 14A and Rule 8D have no application and no disallowance can be made. Though many of the judgements have been rendered prior to introduction of Rule 8D, it may be noted that Rule 8D is only a machinery/ mechanism to compute the disallowance. The Rules can never prevail over the provisions of the Act. If the facts of the case demand no disallowance, the computational provision does not come into picture at all. Also, the circulars issued by the CBDT do not have binding force on the assessee.

Accordingly, where no exempt income is received or receivable during the relevant previous year, provisions of Section 14A shall not apply. It may however be noted that recourse to other Sections is available with the department such as Section 37(1) or Section 36(1)(iii) where the expenditure is stated to be not incurred for the purpose of business of the assessee.

The question which now arises is whether disallowance can exceed the exempt income. The Delhi High Court in Joint Investments Pvt Ltd v CIT [2015] held that Section 14A or Rule 8D cannot be interpreted so as to mean that the entire tax exempt income is to be disallowed. The window for disallowance is indicated in Section 14A of the Act, and is only to the extent of disallowance of expenditure '*incurred by the assessee in relation to tax exempt income*'.

Accordingly, the tax exempt income cannot be disallowed entirely. This judgement is particularly helpful to those assessees whose investments are capable of earning two streams of income – one exempt and the other taxable; and the exempt income is a miniscule portion of the total income.

Section 14A vis-à-vis Section 115JB

As per the Explanation to Section 115JB, expenditure relatable to income to which the provisions of Section 10 (except 10(38)), 11 and 12 is applicable, to the extent debited to the Profit and Loss Account, are to be added back to the net profits for the purpose of computing book profits. Whether for the purpose of determining the amount to be added back, Section 14A should be applied? It was held by Mumbai Tribunal in the case of DCIT vs. Vijay Profiles Ltd. 64 taxmann.com 52 [2015] that the disallowance determined u/s 14A shall be added back to the net profits for the purposes of computing the book profits.

However, a better view probably would be that Section 115JB is a distinct code in itself and Section 14A, as inserted after Section 14 which provides for income classified under the five heads of income, should be applied only for computing income under those five heads only. In the absence of any specific mechanism being prescribed u/s 115JB for the purposes of determining the amount of expenditure relatable to income exempt u/s 10, 11 or 12, the principle of apportionment of expenditure as was laid down by Apex Court prior to introduction of Section 14A may be applied. Furthermore, LTCG subjected to STT which is exempt u/s 10(38) forms part of the book profits. Accordingly, the expenditure relatable thereto even though disallowed u/s 14A, should not be added back in computing the book profits.

Disallowance u/s 14A in respect of expenditure where dividend earned on Shares held as stock-in-trade

Shares in a company can be held either as capital asset or stock-in-trade. If the same are held as stock-in-trade, their sale is not exempt from tax. The only exempt income from such shares can be in the form of dividend. The question whether Section 14A will be applicable in this case has been an area of litigation for quite some time. Judgements which have taken a view that Section 14A shall not apply is based on the premise that the intention of the parties was not to earn dividend income and the earning of such exempt income was incidental to the business carried on by the assessee of trading in shares. Judgements against the assessee are

primarily based on the ratio laid down by Bombay High Court in Godrej and Boyce Manufacturing Co. wherein the hon'ble court after examining the genesis of the provision of section 14A, held that the same has been enacted to overcome the incidence of non-disallowance of expenditure - in view of the judicial precedents by the apex court - where there is a one indivisible business giving rise to taxable as well as exempt incomes. That is, as in the instant case, where the share trading business yields both taxable income in the form of share trading profit and tax-exempt income by way of dividend income. Therefore, section 14A will also apply to shares held as stock-in-trade. Further, in the case of DCIT vs. Damani Estates & Finance Private Ltd. [2014] 44 taxmann.com 385, the ITAT (Mum) after concluding that Section 14A is applicable held that where two streams of income are generated from the same investment the expenditure incurred needs to be adequately apportioned between the taxable and non-taxable income.

Way forward, the following arguments in favour of the assessee are worth mention:

- The Bombay High Court in a writ petition (No. 1753 of 2016) filed by HDFC Bank Ltd discussed the binding precedent of Godrej and Boyce (supra) in the context of Section 14A applicability to stock-in-trade. A decision would be considered as a binding precedent only if it deals with/ decides an issue, which is a subject matter of consideration/ decision before a co-ordinate or a subordinate court. It is axiomatic that a decision cannot be relied upon in support of the proposition that it did not decide. Therefore, it is only the ratio decidendi, i.e. the principle of law that decides the dispute, which can be relied upon as a precedent and not even any obiter dictum or casual observations. The High Court observed that on examination of the decision of Godrej and Boyce, the issue (applicability of Sec 14A to stock-in-trade) of the present case was not decided therein, and no view even as an 'obiter dictum' on the issue was expressed.

  The decision of Godrej and Boyce is not a precedent for the issue in the instant case and could not be relied upon.
- Judgement of the Bombay High Court in the case of India Advantage Securities (ITA 1131 of 2013) may be referred to. Although, the Court dismissed the Revenue's appeal at the stage of admission on the ground that no question of law arises for consideration from the order of the Tribunal, the order still has persuasive value considering the fact that it was relied upon in the writ petition filed by HDFC Bank (supra).
- With the recent amendment in Section 115-O and making a reference to speech of the FM while presenting the Union Budget 2014, it can reasonably be argued that incidental

income in the form of dividend has already suffered taxation in the hands of the Company in the form of dividend distribution tax.

Shares held for strategic business purpose

Where investments are made for strategic business purposes by utilizing surplus funds, the dividend income if any earned therefrom is purely incidental. The primary purpose of such investments is commercial expediency. Earning of dividends therefrom is only incidental to main purpose of such investments. Ref: - Gujarat High Court in the case of CIT vs. Suzlon Energy Ltd. [2013] 33 taxmann.com 151, Chennai Tribunal in the case of EIH Associated Hotels Ltd. v. DCIT, ITO v. Pioneer Radio Training Services Pvt. Ltd. (ITA No. 4448/Del/2013) (Order Dated 19-1-2015), Delhi ITAT

The issues discussed above are few of the many issues which arise in the context of Section 14A. Though the Section was introduced long back, it can only be said that dust is yet to settle considering the number of litigations which arise even today.