

Controversial Issues in Section 14A

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Section 14A – Expenditure incurred in relation to income not includible in total income

- (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 prescribed, 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 where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act:
- **Provided** that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001.

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;
 - (ii) 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 in accordance with the following formula, namely:-

$$A * \frac{B}{C}$$

Where **A** = amount of expenditure by way of interest other than the amount of interest included in clause (i) incurred during the previous year ;

B = the average of 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 ;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year ;

(iii) 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.

- (3) For the purposes of this rule, the "total assets" shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

ACIT vs. Mohan Exports (P.) Ltd. [138 ITD 108 (Delhi)]

- **Facts:**
- Assessee had made investments in shares of companies and units of mutual funds for AY 2008-09. AO held that the investments were made with a view to earn dividend and hence, provisions of Sec. 14A and Rule 8D were applicable. Consequently, disallowance was made under Rule 8D(2)(ii) and 8D(2)(iii).
- On appeal, CIT(A) examined assessee's bank account and found that such investments had been made out of interest free funds available with the assessee. Hence, he held that no disallowance was warranted under Rule 8D(2)(ii).

- **Held:**
- On Revenue's appeal, it was held by the Hon'ble ITAT that Rule 8D(2)(ii) deals with a case where assessee has incurred expenditure by way of interest which is not directly attributable to any particular income or receipt.
- **Since CIT(A) has recorded a finding that interest is not directly related to receipts by way of dividends, it follows that payment of interest is in respect of income other than dividend income.** In such a situation, interest can't be said to be a kind of general expenditure incurred for earning various kinds of incomes. Hence, provisions contained in Rule 8D(2)(ii) is not applicable.

ACIT vs. Torrent Pharmaceuticals Ltd. [137 ITD 301 (Ahmedabad)]

- **Facts:**
- AO made disallowance of administrative expenses u/s 14A of the Act on estimated basis.
- On appeal, CIT(A) was also of the view that certain administrative efforts were necessarily required for earning the exempt income. Hence, the said addition was confirmed by him.

- **Held:**
- On appeal, following decision of Hon'ble Kerala High Court in the case of CIT vs Catholic Syrian Bank Ltd (207 Taxman2), the Hon'ble ITAT held that there is no prescribed formula for disallowance of proportionate administrative cost attributable to earning of tax free income until Rule 8D came into force.
- It was further held that proportionate disallowance u/s 14A should be limited to only interest liability and not to overhead or administrative expenditure.
- Accordingly, the impugned addition, being on estimate basis was deleted.

ACIT vs. Novel Enterprises

[52 SOT 127 (Mumbai)]

- **Facts:**
- Assessee had utilized interest bearing funds for making loan/capital contribution to a Partnership Firm in which it was a partner. It had received interest income and share in profits from the said Partnership Firm.
- AO was of the view that interest expenditure incurred by assessee had resulted in taxable as well as tax free income and hence, that portion of interest which related to share of profit was liable to be disallowed u/s 14A for A.Y.2005-06.
- On appeal, CIT(A) deleted the said disallowance after noting that in the Partnership Deed, it was nowhere stipulated that sharing of profit was dependent on contribution of funds.

- **Held:**
- Indian Partnership Act, 1932 does not contemplate or stipulate capital contribution by the partner as one of the conditions for a partnership firm.
- Sharing of profit/loss is the only condition (S.4 of P Act)
- Therefore, it cannot be said that contribution in the capital of the Partnership Firm has resulted into share of profit in the hands of the assessee.
- Therefore no disallowance is called for u/s 14A of the Act.

Bayer Bio Science (P.) Ltd. vs. ACIT [51 SOT 16 (Mumbai)]

- **Facts:**

- Assessee had earned dividend income from investments made out of own funds as was evident from its reserves and surplus account which has gone up by Rs.55.55 crores for A.Y.2007-08 .
- Still, assessee offered Rs.1,66,000/- as disallowance in respect of other expenses which could be said to be attributed to earning of dividend.
- AO rejected assessee's explanation and made disallowance of a higher amount u/s 14A.
- The said disallowance was confirmed by DRP also.

- **Held:**
- On appeal, the Hon'ble ITAT found that assessee had sufficient non-interest bearing funds for making the concerned investments and hence, no direct costs were involved in funding the said investments. [followed Reliance Utilities (313 ITR 340)(Bom)]
- Assessee had offered Rs.1,66,000/- as direct and indirect costs in earning dividend and neither AO nor DRP pointed out any infirmities in the same.
- Hence, it was held that the disallowance offered by assessee was fair and reasonable and AO ought to have accepted the same.

CCI Ltd. vs. JCIT

[250 CTR 291 (Karnataka)]

- **Facts:**
- Assessee was a dealer in shares and securities. It had purchased shares of a company by availing an interest-free loan and had paid certain amount for brokering the same.
- 63% of said shares were sold and income derived thereon was offered to tax as business income. Remaining 37% shares remained unsold on which the assessee earned dividend income.
- AO held that the brokerage expenditure was directly attributable to the earning of dividend income and disallowed the same. On appeal, CIT(A) confirmed the order passed by AO.

- On second appeal, the Hon'ble ITAT held that the expenditure which was relatable to earning of dividend income, though incidental to trading of shares, was to be disallowed u/s 14A.
- However, Hon'ble ITAT found that entire expenditure was not relatable to dividend income only as the loan was utilized for purchase of shares and profit earned on sale of certain shares out of those shares (i.e. 63% shares) had been offered as business income.
- Hence, Hon'ble ITAT directed AO to bifurcate all the expenditure proportionately and allow the expenditure in accordance with law.

- **Held:**

- On appeal to the Hon'ble High Court, it was held that when no expenditure is incurred in earning dividend income, no notional expenditure could be deducted from the said income.
- Assessee had earned dividend income on 37% shares remaining unsold for which the assessee had not incurred any expenditure at all.
- When the assessee has not retained shares with the intention of earning dividend income and the dividend income is incidental to the business of sale of shares, 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.

- Accordingly, the impugned orders were set aside.

Gillette Group India P. Ltd. vs. ACIT [16 ITR(Trib) 57 (Delhi)]

- **Facts:**

- Assessee had claimed total expenditure of Rs.49,04,028/- in the profit and loss account. AO disallowed Rs.2,37,59,757/- u/s 14A which was reduced to Rs.1,78,83,842/- by the CIT(A).

- **Held:**

- On second appeal, the Hon'ble ITAT held that the disallowance u/s 14A cannot exceed the expenditure actually claimed by the assessee. Hence, AO and CIT(A) were not justified in making disallowance in excess of total expenditure debited to profit and loss account.

CIT vs. Kribhco

[252 CTR (Del) 374]

- **Facts:**
- Assessee had claimed deduction u/s 80P(2)(d) in respect of dividend and interest received from a Co-Operative society. AO held that the said incomes were not included in total income of the assessee and hence, he made disallowance u/s 14A out of interest expenditure and employees benefit & remuneration.
- On appeal, both CIT(A) and the Hon'ble ITAT deleted the said addition.

- **Held:**
- On Revenue's appeal, the Hon'ble High Court held that no disallowance u/s 14A can be made against the income which is entitled to deduction u/s 80P(2)(d).
- Firstly, income of an assessee is computed by applying the provisions of Chapter IV, V and VI. From this income, deductions are permitted and allowed in terms of Chapter VI-A. Deduction under Chapter VI-A doesn't mean that deduction allowed has the effect that such income ceases to be part of total income.
- The expression "Income which does not form part of total income" refers to nature, character or type of income and not the quantum.

- Sec. 14A states that for the purposes of computing total income under Chapter IV, no deduction shall be allowed in respect of expenditure incurred in relation to income which does not form part of total income.
- Since the incomes qualifying for deduction under Chapter VI-A do form part of income, no disallowance can be made u/s 14A.

ACIT vs. Spray Engineering Devices Ltd. [53 SOT 70 (Chandigarh)]

- **Facts:**

- Consequent to a disallowance of Rs.14,05,700/- u/s 14A, AO also re-computed Book Profits of the assessee u/s 115JB by adding the sum of Rs.14,05,700/- being adjustment as per *Explanation 1(f)* to S. 115JB for A.Y. 2006-07. On appeal, CIT(A) deleted the said addition.
- Further, assessee had adopted a business strategy whereby it made investment by way of shareholding in a sick sugar mill in order to take over the said company for widening its operations of business. Assessee had no intention to earn any dividend from such investment. Still, AO made disallowance u/s 14A which was confirmed by CIT(A).

- **Held:**
- On Revenue's appeal as regards first issue, the Hon'ble ITAT held that as per *Explanation* to S. 115JB, book profit is defined to be the net profit shown in profit and loss account as increased/reduced by amounts specified in clauses mentioned thereunder. Disallowance u/s 14A is not covered by the aforesaid clauses and hence, order of CIT(A) in deleting addition of Rs.14,05,700/- made while computing book profits u/s 115JB was upheld.

- On second appeal by assessee as regards the second issue, the Hon'ble ITAT held that once assessee has been found to have made a business investment by way of shares in related line of business, the said investment though held by way of shares in the said company cannot be subjected to disallowance u/s 14A.
- In the facts of present case, investment was purely of business nature as the company in which the amount was invested was a loss making company and there was no question of earning any dividend income from such investment. Hence, there is no merits in the orders of the lower authorities in making disallowance u/s 14A.

Avshesh Mercantile (P.) Ltd. vs. DCIT [148 TTJ (Mumbai) 607]

- **Facts:**
- Assessee paid premium to premium note holders and invested proceeds of the said premium notes (OCPN) in shares/debentures of a company. Dividend income and long term capital gain from the said investment were exempt from tax u/s 10(23G). Hence, AO held that provisions of S. 14A were applicable and accordingly, he disallowed entire premium paid by the assessee on redemption of premium notes.
- On appeal, the CIT(A) upheld the said disallowance.

- **Held:**
- On second appeal, the Hon'ble ITAT found that as per the relevant notification issued u/s 10(23G), such exemption was initially granted for specific period only i.e. from Asst. Years 1999-00 to 2001-02 and later, it was extended upto Asst. Year 2004-05.
- Thus, premium paid by assessee can't be regarded as an expenditure incurred exclusively in relation to earning of exempt income. Moreover, the said investment has the potential of generating taxable income also in the form of short term capital gain, etc.

- Further, the assessee had not earned any exempt income during the years under consideration. Following the decision of Delite Enterprise (ITA No.2983/M/2005) as confirmed by the Mumbai High Court (IT Appeal No.110 of 2009) it was held that when no exempt income is earned at all, the question of disallowance u/s 14A does not arise.
- Hence, it was held by the Hon'ble ITAT that the disallowance made by AO u/s 14A and confirmed by CIT(A) was to be deleted.

Auchtel Products Ltd. vs. ACIT [52 SOT 39 (Mumbai)(URO)]

- **Facts:**

- The assessee earned certain exempt income without offering any amount as disallowance u/s 14A for A.Y.2008-09. AO computed disallowance by applying Rule 8D.
- On appeal, assessee submitted that there was no nexus between interest bearing funds and investments from which such exempt income has been earned.
- CIT(A) was not convinced with the assessee's submission and hence, he confirmed the said disallowance.

- **Held:**
- On second appeal, the Hon'ble ITAT observed that a bare perusal of sub-section (2) and (3) of S. 14A indicates that AO shall determine amount disallowable as per Rule 8D if he is not satisfied with the correctness of claim of the assessee. Such satisfaction can be reached only when claim of assessee has been verified.
- If AO gets satisfied with assessee's claim, there is no need to compute disallowance as per Rule 8D. It is only when AO is not satisfied with the correctness of claim of assessee in respect of such expenditure or no expenditure having been incurred in relation to exempt income that the mandate of Rule 8D will operate.

- From the Asst. Order, it was observed that AO simply kept assessee's submission on record without properly appreciating as to whether the same were correct or not. AO proceeded on the premise as if disallowance as per Rule 8D is automatic irrespective of the genuineness of assessee's claim. It is an incorrect course adopted by the AO.
- Hence, the Hon'ble ITAT restored the matter to the file of AO to re-compute disallowance, if any, in accordance with above observations after duly examining assessee's claim in this regard.

Vishnu Anant Mahajan vs. ACIT [137 ITD 189 (Ahmedabad)(SB)]

- **Facts:**

- Assessee was deriving income by way of share of profit from a Partnership Firm, capital gains, interest, dividend and house property. He had claimed certain expenses and depreciation on motor car owned by him.
- AO was of the opinion that since share in profits of firm is exempt in the hands of the assessee, provisions of S.14A shall be applicable. Hence, he made disallowance u/s 14A.
- On appeal, CIT(A) was of the view that expenses and depreciation do not pertain to the assessee as an individual, but pertain to the Partnership Firm.

- Since the share in profits of firm is exempt in the hands of a partner as per S.10(2A), provisions of S.14A are applicable. Since the assessee derived 76% of professional income as share from the firm and balance amount by way of interest and remuneration from the firm, CIT(A) allocated expenses proportionately. Thus, 76% of the expenditure was disallowed and business income by way of remuneration and interest from the firm was taxed in the hands of the assessee after allowing 24% of the expenditure.

- **Held:**
- On appeal, the Hon'ble ITAT held that as the share in profits of firm is exempt in hands of partner, provisions of S. 14A are rightly applicable. Hence, CIT(A) was right in allocating the expenditure proportionately.
- Further, it was also held that S. 14A deals only with the expenditure and not with any statutory allowance admissible to the assessee. Depreciation is a statutory allowance as per S. 32 and hence, provisions of S. 14A would not apply in respect of depreciation.

DCIT vs. Arihant Foundations & Housing Ltd. [18 ITR(Trib) 588 (Chennai)]

- **Facts:**

- Assessee earned dividend income which was claimed as exempt u/s 10(34). However, it had not attributed any expenditure towards earning such income.
- Assessee had made huge investments in its sister concern by way of “Share application money”.
- AO has noted in the Asst. Order that funds of the assessee included share capital, shareholder earnings and borrowed funds. The investments could have very well been made out of such funds. There was no direct nexus established between borrowed funds and investments made by the assessee.

- AO noted that assessee had incurred routine expenditure for establishment and administrative purposes. According to him, a portion of managerial staff remuneration and director's remuneration could be attributed to such investments. He worked out disallowance u/s 14A at Rs.70,38,725 as per Rule 8D.
- On appeal, CIT(A) observed for the impugned Asst. Year i.e. AY 2006-07, Rule 8D could not apply. Hence, disallowed u/s 14A must be made on a reasonable basis. Accordingly, he held that a disallowance of Rs.50,000/- shall be reasonable.

- **Held:**
- On Revenue's appeal, the Hon'ble ITAT observed that assessee had made huge investments in share application money which, by itself, cannot yield any dividend unless shares were allotted against such money.
- Further, it found that CIT(A) was right in holding that Rule 8D shall not apply to the impugned Asst. Year.
- Also, the assessee had sufficient interest free funds for making such investments.
- Hence, in such circumstances, the Hon'ble ITAT upheld the order of the CIT(A).

Justice Sam P. Bharucha vs. ACIT [25 taxmann.com 381 (Mum-Trib)]

- **Facts:**
- For A.Y. 2006-07, Assessee had earned dividend income from mutual funds and shares besides interest on RBI tax-free bonds which are exempt income.
- AO made disallowance u/s 14A by applying Rule 8D.
- On appeal, CIT(A) confirmed the disallowance made by AO.

- **Held:**
- On further appeal, the Hon'ble ITAT held that when it is possible to determine actual expenditure in relation to exempt income or when no expenditure has been incurred in relation to exempt income, then principle of apportionment embedded in S. 14A has no application.
- There should be a live nexus between the expenditure incurred and income not forming part of total income for making disallowance u/s 14A.
- No notional expenditure can be apportioned for the purpose of earning exempt income unless there is an actual expenditure in relation to earning exempt income.

- Expenditure incurred and claimed by the assessee has direct nexus with his professional income. AO has not pointed out that certain expenditure is incurred for earning exempt income or for inseparable and indivisible activities comprising of professional as well as activities on which exempt income has been earned.
- In absence of any such instance of expenditure, finding of AO or any other material to show that expenditure incurred by assessee against taxable income has any relation with earning exempt income, provisions of S.14A cannot be applied in assessee's case.
- Hon'ble ITAT also held that Rule 8D is not applicable to the year under consideration i.e. AY 2006-07.

Kirloskar Oil Engines Ltd. vs. DCIT [24 taxmann.com 110 (Pune)]

- **Facts:**

- For A.Y. 1999-2000, Assessee had received dividend of Rs.4,10,60,955 vide 5 dividend cheques. Assessee had not incurred any interest expenditure for earning such exempt income.
- AO disallowed Rs.20,53,048/- being 5% of the total dividend income u/s 14A.
- On appeal, CIT(A) restricted the said disallowance to Rs.50,000/- on the ground that ad hoc disallowance at the rate of 5% of total dividend income was too high.

- **Held:**
- On Revenue's appeal, the Hon'ble ITAT held that CIT(A) had restricted the disallowance to Rs.50,000/- on account of employee cost, infrastructure cost, etc. for earning the dividend income and the same being reasonable, needs to be upheld.
- Since AO has not given any finding that assessee had incurred any interest expenditure on borrowed funds and has also not disputed the fact that the assessee had received only 5 dividend cheques, disallowance @ 5% is unjustified and order of CIT(A) in restricting the same to Rs.50,000/- appears to be reasonable.

M/s Suzlon Energy Ltd. vs. DCIT [ITA Nos.3911/Ahd/07 & 1367/Ahd/08]

- **Facts:**
- AO had included investment in foreign subsidiaries while working out disallowance u/s 14A.
- Out of the total disallowance of Rs.3,06,48,988/- u/s 14A, disallowance of Rs.2,56,29,272/- was on account of interest expenditure. Out of this interest expenditure, interest considered by AO in respect of investment in “Foreign subsidiaries” is to the extent of Rs.1,63,36,353/- and balance Rs.92,92,919/- is in respect of investment in “Indian Subsidiaries”.
- Further, assessee had sufficient own funds for making such investments in its subsidiaries.
- On appeal, the said disallowance was deleted by CIT(A).

- **Held:**
- On second appeal, the Hon'ble ITAT held that disallowance u/s 14A out of interest expenditure with respect to investment in "Foreign subsidiaries" is not called for since dividend from foreign subsidiaries is taxable in India.
- Regarding balance investments in "Indian subsidiaries" also, since the assessee had sufficient own funds for making the said investment and AO had not given any finding regarding nexus between interest bearing funds and investment in Indian subsidiaries, no disallowance was justified.

ACIT vs. Champion Commercial Co. Ltd. [ITA No.644/Kol/12 & CO 55/Kol/12]

- **Facts:**
- For A.Y. 2008-09, Assessee had exempt dividend income but had not offered any amount as disallowance u/s 14A.
- AO was not in agreement with the contentions of the assessee as regards non applicability of S.14A and hence, he made disallowance by following Rule 8D.
- On appeal, the CIT(A) reduced the said disallowance substantially by re-computing the same as per Rule 8D. The disallowance was reduced on account of change in calculation under Rule 8D(2)(ii).

- **Held:**
- On further appeal, the Hon'ble ITAT observed that the definition of variable "A" embedded in formula under Rule 8D(2)(ii) is clearly incongruous inasmuch as while it specifically excludes interest expenditure directly related to "Exempt income", it does not exclude interest expenditure related to "Taxable income".
- Resultantly, while Rule 8D(2)(ii) admittedly seeks to allocate "expenditure by way of interest which is not directly attributable to any income or receipt", it ends up allocating "expenditure by way of interest which is not directly attributable to any income or receipt ***plus, interest which is directly attributable to "Taxable income"***".

- This incongruity arises because as per the wordings of Rule 8D(2)(ii), out of total interest expenses, interest expenses directly attributable to “Tax exempt income” are excluded, while interest expenses directly attributable to “Taxable income”, even if any, are not excluded.
- Hence, interest expenses directly attributable to exempt income as well as taxable income, both need to be excluded from the definition of variable “A” in formula as per Rule 8D(2)(ii) because it is only then that “Common interest expenses” which are to be allocated as indirectly relatable to taxable income and tax exempt income can be computed.

- Hon'ble ITAT made it clear that “Common expenses” which are to be allocated in terms of formula under Rule 8D(2)(ii) will only be such expenses as are neither attributable to borrowings specifically used for tax exempt income or receipts, nor are directly attributable to borrowings specifically used for taxable income or receipts. With these directions, the Hon'ble ITAT restored the matter to the file of AO.

State Bank of Mauritius Ltd. vs. DDIT [ITA No.2254 & 3005/Mum/2005]

- **Facts:**
- Assessee had invested Rs.10 crores in tax free bonds out of borrowed funds and claimed exemption in respect of interest from the same.
- Since assessee had not offered any amount as disallowance u/s 14A, AO made disallowance by applying 9% as interest on borrowed funds to the extent of investment in tax free bonds.
- On appeal, CIT(A) deleted the said disallowance as the assessee had demonstrated that it had sufficient interest free funds for making the said investment.

- **Held:**
- On Revenue's appeal, the Hon'ble ITAT found that as per Article 7(3) of the Indo-Mauritius DTAA, deduction in respect of expenses which are incurred for the purposes of business of the permanent establishment shall be allowed. The said article does not provide for limiting deductibility of expenses as per the provisions of the Act.
- Hon'ble ITAT was of the view that benefit of such article can be availed in respect of Sections like 40, 43B, 44C, etc. but cannot be availed in respect of S.14A.

- Sections 40, 43B, 44C, etc provide for disallowance in respect of expenses which are otherwise allowable. It is because of such limit or breach of stipulation that the otherwise deductible expenses become non-deductible or deductible at a lower rate.
- S.14A is quite different as it contains a fundamental principle that any expenditure in relation to an income not includible in total income shall not be allowed as deduction. Thus, S.14A snatches away the deductibility of expenses incurred in relation to exempt income.

- It is not a case that expenses are otherwise deductible but have become non-deductible due to the operation of S.14A. Rather, such expenses do not qualify for deduction at the very first instance. Hence, disallowance u/s 14A is justified in assessee's case.
- However, since the assessee had repaid the loan taken out of own interest free funds on the very next day, AO was directed to calculate disallowance u/s 14A on Rs.10 crores for one day at the rate charged by RBI on the loan advanced to the assessee.

Thank You

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