EAST

Question 1] What is the legislative history of Sec 14A?

Chronology of Sec 14A introduction can be explained as follows:

a) By the Finance Act of 2001, Parliament enacted Section 14A with retrospective effect from 1st April 1962 to amend the law by taking away the basis of the judgments of the Supreme Court in Indian Bank, Maharashtra Sugar and Rajasthan State Warehousing Corporation.
The judgements are briefly discussed hereunder:

CIT v/s Indian Bank [(1965) 56 ITR 77 (SC)]

The assessee carried on the business of banking and the interest received on its investment in Government securities was exempt from income tax. The assessee claimed a deduction of interest paid to depositors under Section 10(2)(iii) of the Income Tax Act, 1922.

The Assessing Officer, Appellate Commissioner and the Tribunal disallowed a portion of that on the ground that it was paid on money borrowed for investment in tax free securities. Eventually, the Hon'ble Supreme Court held that the interest paid by the bank on the money borrowed from its various depositors had to be allowed in its entirety and there is no scope for making any disallowance of the proportionate part of the interest referable to the monies borrowed for the purchase of securities whose interest was tax- free.

CIT v/s Maharashtra Sugar Mills [(1971) 82 ITR 452 (SC)]

Assessee company owned extensive lands on which it grew sugarcane and used the sugarcane for the manufacture of sugar in its factory. The assessee company was managed by managing agents who were entitled to commission which it claimed as deduction.

The ITO disallowed a portion of the sum on the ground that the same related to the commission of the managing agents for managing the sugarcane cultivation part of the business. The Tribunal as well as High Court deleted the addition by observing that it was one single indivisible business. The Hon'ble Supreme Court observed that the entire managing agency commission was expended for the purpose of the business carried on by the assessee and was allowable in entirety notwithstanding the fact that the income from a part of that business was not exigible to tax.

Rajasthan State Warehousing Corporation vs. CIT [(2000) 242 ITR 450 (SC)]

The assessee was a State Government corporation who derived its income from interest, letting out of warehouse and administration charges for procurement of foodgrains. It claimed deduction of expenditure amounting to Rs. 38.13 lakhs under s. 37 of the Act. The ITO allowed only so much of the expenditure as could be allocated to the taxable income and disallowed the rest of it which was referable to the non-taxable income, being exempt under s. 10 (29) of the Act. The Tribunal and the High Court confirmed the disallowance. Supreme Court laid down following principles:

(i) if the income of an assessee is derived from various heads of income, he is entitled to claim deduction permissible under the respective head, whether or not computation under each head results in taxable income;

(ii) if the income of an assessee arises under any of the heads of income but from different items, e.g., different house properties or different securities, etc., and income from one or more items alone is taxable whereas income from the other item is exempt under the Act, the entire permissible expenditure in earning the income from that head is deductible; and

(iii) in computing the "profits and gains of business or profession" when an assessee is carrying on business in various ventures and some among them yield taxable income and the others do not, the question of allowability of the expenditure under s. 37 of the IT Act, 1961, will depend on : (a) fulfilment of requirements of that provision and (b) on the facts whether all the ventures carried on by him constituted one indivisible business; if they do the entire expenditure will be a permissible deductible but if they do not, the principle of apportionment of the expenditure will apply, because there will be no nexus between the expenditure attributable to the venture not forming an integral part of the business and the expenditure sought to be deducted as the business expenditure of the assessee.

Memorandum explaining the provisions of the Finance Bill of 2001 provided the following rationale for the insertion of Section 14A:

“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.

The proposed amendment will take effect retrospectively from 1st April, 1962 and will accordingly, apply in relation to the assessment year 1962-1963 and subsequent assessment years.”

b) The proviso was inserted by the Finance Act of 2002 with retrospective effect from 11 May 2001;

c) Sub sections (2) and (3) were inserted in Section 14A by the Finance Act of 2006 with effect from 1 April 2007; Memorandum explaining the Finance Bill, 2006

"Method for allocating expenditure in relation to exempt income: Under the existing provisions of s. 14A, it has been provided that for the purpose of computing the total income, 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 the IT Act. However, the existing provisions of s. 14A do not provide the method of computing the expenditure incurred in relation to income which does not form part of the total income. **Consequently, there is considerable dispute between the taxpayers and the Department on the method of determining such expenditure.**

In view of the above, it is proposed to insert a new sub-s. (2) in s. 14A so as to provide that it would be mandatory for the AO to determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with such method as may be prescribed. However, the AO shall be required to adopt the prescribed method if having regard to the accounts of the assessee, he is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to income which does not form part of the total income. It is also proposed to provide that provisions of sub-s. (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.

This amendment will take effect from 1st April, 2007 and will, accordingly, apply in relation to asst. yr. 2007-08 and subsequent years."

d) Rule 8D was inserted by the Income Tax (Fifth Amendment) Rules, 2008 by publication in the Gazette dated 24 March 2008.

Question 2] What are the broad principles to be applied for applicability of Sec 14A?

Whenever any expenditure is **incurred** in relation to income which does not form part of total income, sec 14A becomes operative and disallowance has to be made u/s 14A. Expenditure should actually have been claimed as deductible in the computation. An expenditure which has not been claimed against any income in the computation cannot be disallowed u/s 14A. It was held that in CIT v/s Winsome Textile Industries [(2009) 319 ITR 204 (P&H)] disallowance has got to be made under s. 14A only if any expenditure relating to the earning of income which is not chargeable to tax has been debited to the accounts by the assessee. It is to be noted that disallowance u/r 8D(2)(ii) and u/r 8D(2)(iii) cannot be held as disallowance of notional expenditure since while upholding the constitutional validity of Sec 14A(2)&(3), Bombay HC has in the case of Godrej & Boyce Mfg. Co. Ltd. Mumbai. v/s DCIT [194 Taxman 213] accepted that

that Rule 8D(2)(ii) has been inserted since it would have been difficult to allocate the actual quantum of borrowed funds that have been used for making tax free investments & that Rule 8D(2)(iii) has been inserted to attribute part of administrative and management expenditure to tax-exempt income.

The "expenditure incurred" refers to **direct as well as indirect expenditure**. (CIT v/s Walfort Share & Stock Brokers (P) Ltd [41 DTR 233] as well as Godrej & Boyce Mfg. Co. Ltd. Mumbai. v/s DCIT [194 Taxman 213])

The expenditure should have **proximate cause** to the exempt income earned. Even though Supreme Court in Walfort Share & Stock Brokers (P) Ltd has not deliberated on what is meant by proximate cause, the revenue while explaining the rationale behind introduction of Rule 8D(2)(iii) stated before the Bombay HC in the case of Godrej & Boyce Mfg. Co. Ltd. that even indirect expenses may have a proximate cause to the exempt income, and the same must hence be disallowed. For example, if the staff employed in an office partake in both manufacturing and dividend business, that proportion of the staff (indirect) expenses incurred in relation to the dividend business will be disallowed.

The expenditure so incurred should be **in relation to** exempt income. The words "in relation to" have been explained in the decision of ITO v/s. Daga Capital Management (P) Ltd. [119 TTJ (Mumbai)(SB) 289]. There should be dominant and immediate connection between expenditure incurred and exempt income. Dominant and immediate connection refers to first degree of relation between the two things. However, it would cease to be dominant if the degree of relationship slips from first to second. It is noticed that there is a dominant and immediate connection between the expenditure incurred by the assessee in the shape of interest on borrowings for purchase of shares and the dividend income. It is only due to the investment in the shares that the dividend income has resulted. Such investment results into two incomes, viz., the profit on its sale and the dividend. Both these incomes fall on the same platform and are the direct result of investment. If a person invests in the shares from which dividend income is earned and thereafter such dividend is deposited in the bank from where the interest income results, in such a situation the relation between the interest paid by the assessee on the borrowed funds for the purchase of shares with the dividend income is dominant and immediate, being that of the first degree but the relation of such interest paid with the interest income earned on the amount invested in the bank, would be of second degree, being indirect and non-immediate.

If the expenditure, <u>whether direct or indirect</u> has been incurred in relation to taxable as well as exempt income, then the expenses which can be **apportioned** to exempt income, having regards to the accounts of the assessee, have to be disallowed u/s 14A(1). [SC in the case of Walfort Share & Stock Brokers (P) Ltd have held that theory of apportionment of expenditures between taxable and non-taxable has, in principle, been now widened under Sec 14A.]

Only when the **AO is not objectively satisfied** with the correctness of the claim having regards to the accounts of the assessee (i.e. proportionate expenses disallowed by the assessee suo-

moto u/s 14A(1)), he can compute the disallowance as per Rule 8D. Before arriving at such a conclusion, the AO should have issued a notice to the assessee, subsequent to which an opportunity to the assessee to place on record all the relevant facts including his accounts should have been given and finally reasons should have been recorded by the Assessing Officer. In conclusion, the onus is on the assessee to disallow expenditure which has been incurred in relation to exempt income failing which the AO can disallow the same by adopting Rule 8D after arriving at an objective satisfaction. Since Rule 8D has been held to operative prospectively from AY 08-09, for the periods prior to AY 08-09, the Assessing Officer must adopt a reasonable basis or method consistent with all the relevant facts and circumstances after furnishing a reasonable opportunity to the assessee to place all germane material on the record and being objectively satisfied that the claim of the assessee is not correct. [Held in the case of Godrej & Boyce Mfg. Co. Ltd.].

Question 3] Can the disallowance u/s Sec 14A by operation of Rule 8D exceed the actual expenditure incurred?

As seen in the previous question, the assessee should have incurred and claimed the expenditure as deductible, only then can the expenditure be disallowed u/s 14A. Going by the same analogy, the assessee can be allowed only that portion of expenditure which he has claimed as deductible in the return of income. The reverse would also thus hold true and the disallowance can only be restricted to the expenditure the assessee has claimed as deductible.

Question 4] Can expenditure be disallowed even in the year in which no exempt income has been earned?

The title of the section 14A refers to "income ***not includible*** in the total income". Inference has been drawn from the title of section 14A by ITAT, Lucknow 'B' Bench in the case of ACIT v/s Ratan Housing Development Ltd. to hold that the eligibility of income sought to be earned and expenditure in pursuit thereto which is incurred, would determine whether such income is includible in the total income or not and that, not actual earning of such income would be a relevant consideration i.e. Sec. 14A speaks of the nature and quality of income includible in the total income and not the actual inclusion of such income in the total income.

Relying on the decision in the case of In Rajendra Prasad Moody [115 ITR 522 (SC)] wherein the Supreme Court held that interest on monies borrowed for purchase of shares was allowable as a deduction u/s 57(iii) irrespective of whether or not there is any yield of dividend to the assessee, the Delhi Special Bench held in the case of Cheminvest Ltd v/s ITO [(2009) 124 TTJ (Del)(SB) 577] that converse of this principle is now applicable i.e. Sec 14A disallows expenditure "in relation to income which does not form part of total income" and in order for the expenditure to be disallowed, actual income need not be earned.

Thus, in principle, disallowance can be also be made in the year in which no exempt income has been earned.

Question 5] Can disallowance u/s 14A be greater than exempt income?

As seen in the previous question, the contention that disallowance can be made even in the year when no exempt income has been earned itself shows that disallowance u/s 14A can be greater than exempt income.

In the case of CIT v/s Smt Leena Ramachandran [ITA No. 1784 of 2009], the dividend income earned was of Rs. 3 lakhs and the disallowance made by tribunal was of Rs 2 lakhs. The Kerala HC commented that the Tribunal was not correct in estimating the s. 14A disallowance to a lesser figure than the interest paid on the borrowing when the whole of the borrowed funds were utilized by the assessee for purchase of shares, thus suggesting that on the facts of that case, the interest paid of Rs. 17,44,310/- should have been disallowed which would have been much greater than dividend income of Rs. 3 lakhs.

Further, the decision in the case of Sanchayita Mercantile (P) Ltd. v/s ACIT [Mum ITAT 'D' Bench- (2008) 25 SOT 57 (Mumbai)] states that there is nothing in the provisions of s. 14A of the Act to the effect that the expenditure disallowed are not to exceed the income, which is not chargeable to tax. Further the aforesaid decision has not been referred to in Daga Capital Management (P) Ltd (supra) and hence not adjudicated upon by the special bench.

Question 6] What are the points to be kept in mind while calculating disallowance u/r 8D?

Certain points are to be borne in mind while applying Rule 8D:

a) Rule 8D(2)(i) relates to <u>direct expenditure</u> only.[Generally would include interest alongwith incidental expenses for approval and raising of loan]

b) Rule 8D(2)(ii) relates to <u>only interest expenditure</u> which excludes interest which is directly attributable to any particular income or receipt (eg: interest which has proximate cause with taxable income) as well as interest which has already been considered in Rule 8D(2)(i). When considering 'B' of the formula, the investments <u>'which are'</u> as well as <u>'capable of'</u> generating exempt income have to be considered. When considering 'C' of the formula, the total of the asset side has to be considered [except P&L debit balance].

c) Rule 8D(2)(iii) introduced in order to disallow indirect expenditure. 0.5% has to be considered of investments <u>'which are'</u> as well as <u>'capable of'</u> generating exempt income.

Question 7] What are the different indirect expenditures which may have proximate relation with exempt income? How to apportion the indirect expenditure suo-moto?

Since the words 'Expenditure in relation to income' have been used in Sec 14A, indirect expenses to be disallowed can be relating to pre-investment as well as post-investment. <u>Managerial expenses</u> may relate to the management remuneration for the time spent for taking investment decisions, undertaking substantial market research, day-to-day analysis of market trends and taking decisions with regard to acquisition, retention and sale of shares at the most appropriate time. <u>Administrative expenses</u> may relate to expenses relating to liaisoning with the

broker/depository, efforts required to collect the dividend, encashment of dividend warrants in the relevant bank account, accounting for the dividend received. In the case of Haryana Land Reclamation & Development Corporation v/s CIT [(2008) 302 ITR 218], the Punjab and Haryana HC has even disallowed depreciation in an extreme situation where the assessee was not able to prove that the assets were used for business operations.

Question 8] Can disallowance u/s 14A be made when investments are made out of fungible funds and the reserves of the assessee as shown in the Balance Sheet are much more than the investments made during the year?

In the case of CIT v/s Reliance Utilities & Power Ltd [(2009) 313 ITR 340], the Bombay HC noticed that the Tribunal order had recorded a clear finding that even though the assessee had taken borrowed loans, the assessee had interest-free funds of its own which had been generated in the course of the year. Apart from that, the assessee had sufficient reserves including share capital. Thus it made a **presumption** that if there be interest-free funds available to an assessee sufficient to meet its investments and at the same time the assessee had raised a loan it can be presumed that the investments were from the interest-free funds available.

While arriving at this conclusion, the Bombay HC relied on Supreme Court decision in the case of East India Pharmaceutical Works Ltd [(1997) 224 ITR 627 (SC)] and stated that, even though SC did not draw any conclusion in the aforesaid case, it noted/acknowledged Woolcombers of India Ltd decision [(1982) 134 ITR 219 (Cal)] wherein it was held that in a year when entire profits were deposited into OD a/c and the profits were much more than income tax liability, can it be presumed that taxes were paid out of the profits and not out of OD a/c.

In the case of CIT v/s Hero Cycles Ltd [(2010) 323 ITR 518], Punjab and Haryana HC dismissed the contention of the revenue that directly or indirectly some expenditure is always incurred and thus must be disallowed under rule 8D(1)(b) of Sec. 14A. It further held that since it was on record that the entire investments have been made out of the dividend proceeds, sale proceeds, debenture redemption etc. i.e. non-interest bearing funds, disallowance u/s 14A could not stand since it was found that there was no **nexus** between exempt income and expenditure.

After the decision in the case of Hero Cycles Ltd, SC in the case of Walfort Share & Stock Brokers (P) Ltd and Bombay HC in the case of Godrej & Boyce Mfg. Co. Ltd. held that even indirect expenditure would be covered within the ambit of Sec 14A.

Further, Bombay HC in the case of Godrej & Boyce Mfg. Co. Ltd. while upholding the constitutional validity of Sec 14A(2)&(3), accepted the contention of revenue that Rule 8D(2)(ii) has been inserted since it would have been difficult to allocate the actual quantum of borrowed funds that have been used for making tax free investments & that Rule 8D(2)(iii) has been inserted to attribute part of administrative and management expenditure to tax-exempt income. It even distinguished the case of Reliance Utilities & Power Ltd noting that in the judgement of Reliance Utilities & Power Ltd, it was shown that there were interest free owned funds available but not merely reserves. It even noted that the fact that the assessee has utilized its own funds in making the investments would not be dispositive of the question as to whether the assessee had incurred expenditure in relation to the earning of such income.

A view could be taken after analysing the above that if the assessee can prove **by way of presumption or by way of direct nexus** that interest free funds have been utilised in making the investments, then Rule 8D(2)(ii) would not be applicable. However, Rule 8D(2)(iii) continues to be applicable in such a case unless proven otherwise by the assessee by way of suo-moto apportioned disallowance of expenditure in relation to exempt income since inevitably some part of administrative/managerial expenditure is bound to be incurred which may have a proximate cause with the exempt income.

Question 9] Are there any ways in which it can be proved that investments are made out of interest free owned funds?

A practical way to ascertain whether there is any **nexus** between investments and borrowed funds is to scrutinise/analyse the bank statements just as in the case when we have to trace the source of funds with respect to the AIR items in reply to a notice received for scrutiny under Computer-Assisted Scrutiny System (CASS). The loan sanction letter usually refers to the permissible end use of the loan. Thus, it would also be of help in establishing the purpose for which the loan is actually utilised. A separate bank account may be maintained for borrowed funds to show that funds have not been utilised for investments.

A contention was made by the revenue in the case of Godrej & Boyce Mfg. Co. Ltd. that a presumption cannot be drawn merely on the basis of reserves since the reserves on the liabilities side of the balance sheet are represented by a variety of assets on the asset side. The assets could be fixed or non-liquid assets and thus not investible. Even in the case of Reliance Utilities & Power Ltd, the revenue made a contention that the shareholders funds were utilised in acquisition of fixed assets. A way to ascertain whether any **presumption** can be made that the investments are not made from borrowings is to prepare fund flow statements at short time intervals. Fund flow statements essentially show the movements of funds from sources to their application between two dates. Thus, we could ascertain whether any funds have been applied to fixed assets/investments/repayment of debt, etc.

Question 10] Is there a way to apportion indirect expenses which may have a proximate cause to the exempt income?

Just as in costing, we apportion indirect costs to arrive at the total cost per unit, indirect expenses could be apportioned to the exempt income on various reasonable criteria such as direct area attributable, proportionate time spent, etc. Guidance can also be drawn from the Total Cost Plus method adopted under transfer pricing regulations which is typically used in the IT industry to arrive at the man-hour rate of IT professionals.

Question 11] Can disallowance be made in case of investments made out of commercial expediency?

Commercial expediency can arise out of various situations. Most common are investments made in another company to protect/expand one's business interests for which funds may have been borrowed (horizontal/vertical integration business plans). Similarly, there can be a situation wherein funds may have been borrowed to purchase stock exchange membership card and

pursuant to corporatisation of stock exchanges, shares of the stock exchange have been received in lieu of the membership card.

In the case of Smt Leena Ramachandran, the Kerala HC held that since the assessee failed to prove that any benefit had actually been derived from the investment made in the controlling stake of a company, the Supreme Court decision in the case of S.A. Builders Ltd. v. CIT [2007] 158 Taxman 74 (SC) would not be applicable to the facts of the case. It concluded that since the only benefit derived by the assessee from the investment in shares was the dividend income and no other benefit was derived from the company for the business carried on by it, Sec 14A would be applicable to the exempt income in the case under consideration.

Supreme Court in the case of Walfort Share & Stock Brokers (P) Ltd has held that if an income like dividend income is not a part of the total income, the expenditure/deduction though of the nature specified in ss. 15 to 59 but related to the income not forming part of total income could not be allowed against other income includible in the total income for the purpose of chargeability to tax.

Thus, a view can be taken that even though in certain cases, interest income is allowable u/s 36(1)(iii)/37(1) on the principle of commercial expediency, Sec 14A would still govern such expenditure.

But it can be contended that where a strategic investment has been made and it yields specific taxable income and at the same time, it is not practicable to earn dividend from the company in which strategic investment has been made, Sec 14A would have no relevance.

Question 12] Even though AO is satisfied with the claim of disallowance/no-disallowance w.r.t. direct expenditure and interest on borrowings, can he still apply Rule 8D(2)(iii)?

If the AO having regards to the accounts of the assessee is not satisfied about the correctness of claim with respect to indirect expenditure, he can still apply Sec 14A(2)/(3) r.w. Rule 8D(2)(iii) irrespective of the fact that he is satisfied about the correctness of claim of disallowance/no-disllowance w.r.t. direct expenditure and interest on borrowings.

Question 13] If the AO is not satisfied with the correctness of the claim of disallowance made by the assessee suo moto u/r 8D(2), can he disregard the same and adopt any other arbitrary method?

Beginning AY 08-09, it would be mandatory for the AO to determine the amount of expenditure incurred in relation to such income which does not form part of the total income in accordance with Rule 8D if he is not satisfied with the correctness of claim of the assessee. The aforesaid inference can be drawn from the Memorandum explaining the Finance Bill, 2006 with regard to introduction of Sec 14A(2).

Question 14] Whether Sec 14A is applicable to investments made in previous years and when there is no activity during the current year?

In the case of Escorts Ltd. v/s ACIT [Delhi ITAT 'G' Bench - (2006) 102 TTJ (Del) 522], the tribunal took a view that the investment in shares and mutual funds was predominantly made by the assessee in earlier years and no investment was made out of borrowings in the relevant year, and the interest-yielding loan was lent by the company in an earlier year, and therefore no part of interest cost incurred by the assessee during the relevant year can be related to earning of dividend and interest income which are exempt under ss. 10(33) and 10(23G), respectively and therefore, no disallowance can be made under s. 14A. But at the same time since no separate accounts were maintained by the assessee, the tribunal disallowed a part of management and administrative expenses attributable to earning of dividend and interest income.

In the case of Godrej & Boyce Mfg. Co. Ltd., the Bombay HC refused to rely on earlier years tribunal orders of the assessee stating that the fact that assessee had utilized its own funds in making the investments would not be dispositive of the question as to whether the assessee had incurred expenditure in relation to the earning of such income. A view can be taken that it thus suggested that indirect expenses may still have been incurred which may have a proximate cause with the exempt income and thus proportionate disallowance be made in respect of the same.

It may be noted that it would be difficult to contend that reliance be placed on earlier years AO/CIT(A)/Tribunal orders of the assessee on the principle of consistency (res-judicata) to contend that no disallowance at all should be made in the year under consideration since Bombay HC in the case of Godrej & Boyce Mfg. Co. Ltd. held that consistency and definiteness in the approach of the revenue would not apply to the facts of the present case, because of the material change introduced by Section 14A by way of statutory disallowance in certain cases.

Question 15] What would happen in the year when there is taxable (eg: capital gains) as well as non-taxable income (eg: dividend) arising to the assessee?

It may be noted at first that in the case of computation of capital gains, only direct expenditure in connection with transfer is allowable u/s 48(i) and that too only in the year of sale.

In the case of S. Balan alias Shanmugam Balkrishnan Chettiar v/s DCIT [Pune ITAT 'B' Bench - (2009) 120 TTJ (Pune) 397], the interest cost which was capitalised to the cost of investment in shares was allowed to be claimed as part of cost of acquisition u/s 48(ii). It further held that capital gain on the sale of shares being part of the total income of the assessee and not an exempt income, s. 14A has no application.

Guidance can be drawn from aforesaid decision to hold the view that Sec 14A would not have applicability in the case of taxable capital gains be it STCG or LTCG.

Three questions arise therefore:

a) *What would happen in a year in which there is dividend income as well as taxable capital gains?*

SC in the case of Walfort Share & Stock Brokers (P) Ltd held that the theory of apportionment of expenditures between taxable and non-taxable has, in principle, been now widened under s. 14A, thus suggesting that apportionment of expenditure has to be made between taxable and exempt income in case both arise in the same year.

b) *What would happen in a year in which there is no dividend income but taxable capital gains?*

As held in the case of Cheminvest Ltd by Delhi Special bench, Sec 14A applies even in the year in which there is no exempt income arising/accruing. Thus, it would still be possible for the AO to apportion the expenditure between taxable and exempt income and disallow the same proportionately.

c) *What would happen in a case wherein the shares held as capital asset are not sold or are to be sold off-market?*

It has been held in the case of Renaissance Asset Management Co. (P) Ltd. v/s AO [Delhi ITAT 'D' Bench - (2010) 2 ITR (Trib) 765 (Del)] that any expenditure relatable to investment activity has to be construed as expenses incurred for earning dividend income and the same cannot be allowed as per s. 14A, but for working out the same, it is not proper to calculate the same on the basis of capital gain earned by the assesses because even if these investments were not sold in the present year and as a result no capital gain would have been earned, expenses relatable to investment activity are to be disallowed on the basis that the same is incurred for earning exempt dividend income. Guidance may be drawn from the aforesaid decision to hold that in a year when the capital asset has not been sold (holding period of the asset may be short-term or long-term), the expenses should be construed to be incurred in relation to dividend and thus disallowable u/s 14A.

Question 16] As a tax-planning measure, if investments are sold on 30/03 and repurchased on 02/04, would Rule 8D(2)(iii) still be applicable?

If the investments are sold on 30/03 and repurchased on 02/04 in order to contend that in such a case, since there were no investments as at the first and last day of the previous year, Rule 8D(2)(iii) would not be applicable; the assessee would end up paying STCG in the process of avoiding disallowance u/s 14A. Additionally if the assessee would adopt such an approach every year, it runs the risk of the income being characterised as income arising from Business and Profession and thus taxed at a higher rate.

Question 17] Whether Sec 14A is applicable to Dividend re-investment and growth funds?

In the dividend re-investment plans for mutual funds, the dividend which is declared by the mutual fund house is re-invested in the mutual fund units itself. The dividend which is declared is exempt u/s 10(35) and the correspondingly the dividend amount is taken as the cost of the new units purchased out of the dividends. Sec 14A would be applicable in this case.

With respect to growth funds being debt funds, there is no dispute that they are taxable under ITA. Therefore, Sec 14A should not be applicable to income arising from them. In case of equity oriented mutual funds, in view of Sec 10(38), LTCG would be exempt. A view can be taken that till the holding period is short-term, no disallowance should be made and the moment long term holding period starts the disallowance should start. A practical difficulty may be encountered in such a situation if the debt fund with growth option may be purchased after September month of the previous year under consideration, wherein one wouldn't know that before return filing date that debt fund is to be sold within a year of purchase or not.

Question 18] Whether Sec 14A is applicable in case of bonus shares?

A view could be taken wr.t. Rule 8D(2)(i) and (ii) that the expenditure incurred is in relation to the original shares purchased and does not have any direct and immediate connection with the bonus shares. [Usually, borrowing taken for purchase of original shares is repaid on sale of the shares except in a case when the shares have been sold at a loss]. But Rule 8D(2)(iii) may continue to be applicable in case of dividends receivable out of bonus shares.

Question 19] Whether Sec 14A is applicable to Sec 10(2A)?

In the case of Sudhir Kapadia v/s ITO [Mum ITAT 'C' Bench] ITA No. 7888/M/03 and Hitesh Gajaria v/s ITO [Mum ITAT 'H' Bench] ITA No. 993/M/2007, the tribunal relied on SC decision in the case of CIT v/s R.M.Chidambaram Pillai [106 ITR 292] wherein it was held that salary paid to a partner retains the same character as the income as income of the firm. The tribunal then drew conclusion that even share of profit retains the same character as that of the business income of the firm. Thus it cannot be said that share of profit is tax-free altogether in the hands of the partner, it has suffered tax in the hands of the firm.

The diagonally opposite view has been taken in the case of Dharmasingh M. Popat v/s DCIT [Mum ITAT 'H' Bench- (2010) 127 TTJ (Mumbai) 61]. The tribunal observed that by incorporating s. 45(2), 45(3) and 45(4), the legislature has declared its intention in clear terms that partners and the firm are two independent entities not only for the purposes of assessment but also for the purpose of determining the charge of income-tax on the transactions entered into between them. Similarly, from asst. yr. 1993-94 partnership firms have been given a corporate personality in a limited sense by making necessary amendments in the provisions of ss. 10(2A), 28(v), 40(b) and relevant procedural sections which conclusively prove that partnership firm as such is independent from its partners as far as provisions of IT Act, 1961 are concerned. It therefore concluded that Partnership firm being a separate assessable entity for the purpose of IT Act, income charged in the hands of partnership firm cannot be treated as a non-exempt income in the hands of partner of such firm and, therefore, provisions of s. 14A are applicable in computing the total income of such partner in respect of his share in the profits of the firm. Similar view has been taken in few other Mumbai Tribunal cases too.

However, situation would be different where the partner is allotted salary, interest, etc. which would be assessable in the hands of the partner under s. 28(iv) and interest paid by the partner on borrowed capital invested in the firm could be claimed as a deduction. In such a case if any

disallowance is warranted, then the expenditure should be apportioned in the ratio between income from share of profit and salary/interest/remuneration.

Even in a case when disallowance u/r 8D is to be made, what would be the investment value to be taken for the purpose of Rule 8D? One view is that only the Capital a/c balance as at the start and the end of the year is to be taken. Another view is that even Current a/c balance is to be included in the investment figure. It can be noted here that even if Rule 8D(2)(iii) is made applicable in either case, the disallowance would be miniscule. For eg: The share of profit earned by the partner during the previous year is Rs. 20,00,000/- and the expenditure incurred by the partner in relation to share of profit earned from the firm is Rs. 5,00,000/-. Suppose the partner has not borrowed any funds for investment in the capital of the firm and capital account balance of the partner with the firm as at the start of the year is Rs. 50,00,000/- and as at the end of the year stands at Rs. 60,00,000/-. If disallowance is proposed to be made by the AO u/r 8D(2)(iii), then it would amount to disallowance of only Rs. 27,500/- (0.5% of Rs. 55,00,000). Thus, in such cases, it would be beneficial to the partner if disallowance is to be made u/r 8D(2)(iii) rather than suo-moto disallowance by apportionment of expenses between share of profit received from the firm and salary/interest/remuneration received from the firm.

It has been observed that recently many AOs have started disallowing expenditure u/s 14A from Professional books of accounts contending that some part of them are attributable to income generated from investments which are accounted for in the Personal books of accounts. The contention of the AO may not be correct in such cases since the expenditure which is alleged to have been incurred in relation to personal investments should be disallowed u/s 37(1) itself rather than applying Sec 14A and Rule 8D in such cases.

Question 20] Whether Sec 14A is applicable to share of member from AOP/BOI?
The share of a member in the income of AOP/BOI is to be computed as per provisions of Sec 67A when the shares of members are determinate. Further, the computation of tax of members of an AOP/BOI is given in Sec 86. There could be two situations arising out of the above:

a) *When the AOP/BOI is taxable at normal rate and tax is paid:* Where the AOP/BOI is chargeable to tax at the normal rate applicable to individuals, etc, the share of a member therein **shall be included in his total income, but correspondingly, a rebate u/s 86 is provided** to the assessee due to which income-tax is not payable in respect of the share of the member. In such cases, Sec 14A would not have applicability.

b) *When the AOP/BOI is taxable at maximum marginal rate:* Where the AOP/BOI is chargeable to tax at the MMR or rate higher than the MMR, by virtue of Proviso to Sec 86, the share of a member **would not be included in the total income of the assessee**. Thus, in such cases Sec 14A would have applicability.

Question 21] Whether Sec 14A is applicable to cases wherein a company has to pay tax under MAT provisions?

Where the provisions of Sec 115JB are applicable to a company, by virtue of Explanation 1 to Sec 115JB, the book profits have to be increased by the amount of expenditure relatable to exempt income. Thus, expenses which ought to be disallowed u/s 14A are consequentially added back while computing the book profits of the company as per Explanation 1 to Sec 115JB.

Question 22] Whether Sec 14A is applicable to Insurance business?

It has been held in the case of Oriental Insurance Co. Ltd. v/s ACIT [Delhi ITAT 'B' Bench - (2010) 130 TTJ (Del) 388] and in the case of Bajaj Allianz General Insurance Co. Ltd. v/s Addtl CIT [Pune ITAT 'A' Bench - (2010) 130 TTJ (Pune) 398] that Sec. 44 of ITA provides for application of special provisions for computation of profits and gains of insurance business in accordance with Rule 5 of Schedule I to ITA and therefore, it is not permissible to the AO to travel beyond Sec. 44 and Schedule I and make disallowance by applying s. 14A. Thus, 14A has not application to insurance business.

Question 23] Whether Sec 14A is applicable to Banks where investments are required to be made to maintain Statutory Liquidity Ratio?

It has been held in the case of Punjab National Bank v/s DCIT [Delhi ITAT 'G' Bench - (2006) 103 TTJ (Del) 908] that expenditure relatable to income not forming part of total income is disallowable under s. 14A, notwithstanding the fact that investments on which tax-free income was earned were made to maintain minimum statutory liquidity ratio as required by Sec. 24 of the Banking Regulation Act. Thus Sec 14A is applicable to Banks even where investments are required to be made to maintain Statutory Liquidity Ratio.

Question 24] Whether Sec 14A is applicable to agricultural income?

In the case of Haryana Land Reclamation & Development Corporation v/s CIT [(2008) 302 ITR 218], the Punjab and Haryana HC held that payments on account of CPF, gratuity and bonus would be disallowed u/s 14A since the assessee was not able to prove that the said staff was engaged in its business operation and not agricultural operation and since substantial income was being generated out of agricultural farm. Thus Sec 14A is also applicable to assesses who earn agriculture income which is exempt u/s 10(1).

Question 25] Whether Sec 14A is applicable to FCNR a/c and NRE a/c interest?

In the case of Dresdner Bank AG v/s Addtl CIT [Mum ITAT 'F' bench - (2006) 105 TTJ (Mumbai) 149], it has been held that exemption under s. 10(15)(iv)(fa) is allowable in respect of gross interest on foreign currency deposits but any expenditure incurred in relation to earning of exempt income is to be disallowed under s. 14A. Thus, Sec 14A is applicable even to interest earned in FCNR a/c and on the same analogy interest earned in NRE a/c which is exempt u/s 10(15)(iv)(fa) and u/s 10(4)(ii) respectively.

Question 26] Whether 14A is applicable to interest earned on tax-free bonds?

In the case of JCIT v/s B K Patel Family trust [Mum ITAT 'G' Bench - (2006) 9 SOT 583 (Mumbai)], where it was alleged that borrowed money was used to invest in tax free bonds, the matter was remanded back to the AO to verify factual accuracy suggesting that Sec 14A is also applicable on interest earned on tax-free bonds, the most common being u/s 10(15)(i).

Question 27] Whether Sec 14A is applicable to Sec 10A companies?

It has been held in the case of Wipro Ltd v/s DCIT [Bangalore ITAT 'A' Bench - (2010) 34 DTR (Bang)(Trib) 493] that the Sec 10A provides for deduction from the total income in respect of profits and gains of the undertaking. Thus, income of Sec 10A undertaking was held to be assessed under the head 'Profits and gains of business or profession' and then to have been reduced from the total income. It was thus concluded in the aforesaid case that since Sec 14A is applicable for disallowing the expenses in respect of income which is not includible in total income, Sec 14A cannot be invoked when income is deductible under s. 10A.

Question 28] Whether Sec 14A is applicable when Chapter IVA deductions are claimed?

Sec 14A makes it abundantly clear that only expenditure if incurred in relation to income which does not form part of total income is to be disallowed. It would not apply in cases wherein deduction has been claimed by the assessee. Even in the case of ACIT v/s Tamil Nadu Silk Producers Federation Ltd [Chennai ITAT 'B' Bench - (2006) 103 TTJ (Chennai) 716], it has been held that since Sec. 14A prohibits deduction of expenditure incurred only in relation to exempt income and it cannot be applied to the provisions of Chapter VI-A where deductions are to be allowed in computing the total income.

Question 29] Whether Sec 14A is applicable to foreign dividends also?

Foreign dividends are taxable u/s 56 (i.e. head- income from other sources). It was held in the case of Birla Group Holdings Ltd v/s DCIT [Mum ITAT 'F' Bench - (2007) 13 SOT 642 (Mumbai)] that so much of interest as is relatable to amount invested in shares of foreign company, dividend whereof is not exempt under s. 10(33) is to be considered for allowance under Sec 57(iii). Thus, Sec 14A is not applicable to foreign dividends earned.

Question 30] Whether Penalty would be leviable u/s 271(1)(c) by the AO in case expenses are disallowed u/s 14A in the assessment order?

It has been held by Punjab and Haryana High Court in the case of CIT vs. Ajaib Singh & Co. [(2002) 253 ITR 630 (P&H)] that disallowance of an expense per se cannot mean that the assessee has furnished incorrect particulars of its income. Further, it has been held by Supreme Court in the case of CIT v/s Reliance Petroproducts Pvt Ltd [(2010) 322 ITR 158] that a mere making of the claim, which is not sustainable in law, by itself, will not amount to furnishing inaccurate particulars regarding the income of the assessee. Also that merely because the assessee claimed deduction which has not been accepted by the Revenue, penalty under s. 271(1)(c) is not attracted.

In view of the above, penalty cannot be levied if a disallowance is made u/s 14A by the AO in the assessment order.

Question 31] Whether re-opening can be done by an AO on the basis that in earlier years no disallowance u/s 14A was made, wherein in the current year he makes a disallowance u/s 14A?

Suppose the AO in the earlier years had already formed an opinion in his assessment order that no expenditure had been incurred in relation to exempt income and the facts remaining the same in the current year, subsequently, the AO in the current year makes a disallowance u/s 14A. The Supreme Court has held in the case of CIT V/s Kelvinator of India Ltd [320 ITR 561] that though the AO has the power to reassess u/s 147, he does not have the power to review. Thus, even though the AO may make disallowance in the current year, the AO would not be permitted to re-open the case of previous assessment years since it would amount to change of opinion already formed by the respective AO while passing the orders for earlier assessment years.

Question 32] Whether revision can be made by the CIT u/s 263 of the order passed by the AO for increasing the reasonable disallowance made u/s 14A (for AY earlier than AY 08-09) or for adopting Rule 8D in case the AO was satisfied with suo-moto proportionate disallwance made by the assessee (for AY 08-09 onwards)?

It has been held by Supreme Court in the case of Malabar Industrial Co Ltd v/s CIT [(2000) 243 ITR 83 (SC)] that if an AO adopts one of the courses permissible in law and it has resulted in loss of revenue; or where two views are possible and the AO has taken one view with which the CIT does not agree, it cannot be treated as an erroneous order prejudicial to the interests of the revenue unless the view taken by the AO is unsustainable in law.

In view of the aforesaid, revision of order cannot be made by the CIT in such circumstances.

---Thank You--