

Controversies

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Whether disallowance can be made by invoking provisions of S.14A of the Act even in those cases where no income has been earned by an assessee, which has been claimed as exempt during the financial year?

Proposition:

It is proposed that where no exempt income is earned disallowance u/s 14A cannot be invoked.

View Against the Proposition:

Section 14A has been inserted in Chapter IV of the Income Tax Act by the Finance Act, 2001, with retrospective effect from 1-4-1962. This section provides for disallowance of expenditure incurred in relation to income which is not includable in the total income of the assessee (i.e., exempt income). The operative part of this section reads as under. "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.

In exercise of the powers given in section 14A(2), C.B.D.T has issued a Notification No. S.O. 547(E) on 24-3-2008 (299 ITR (ST) 88). This notification amends the Income tax Rules by insertion of Rule 8D providing for a "method for determining amount of expenditure in relation to income not includible in total income". Reading this Rule it is evident that the Rule provides for disallowance of not only direct expenditure incurred for earning the exempt income but also for disallowance of proportionate cost of holding investments. This is clearly contrary to the main objective with which section 14A is enacted.

Broadly stated, Rule 8D provides as under.

(i) The method prescribed in the rule is to be applied only if the A.O. is not satisfied with-

- a) The correctness of the claim of expenditure incurred for earning the exempt income made by the assessee or
 - b) The claim made by the assessee that no expenditure has been incurred for earning exempt income.
- (ii) The method prescribed in the Rule states that the expenditure in relation to income which does not form part of the total income shall be aggregate of the following amounts-
- a) The amount of expenditure directly relating to income which does not form part of total income.
 - b) In the case of interest on borrowed funds which is not directly attributable to any particular income or receipt, the amount computed in accordance with the following formula-
$$\frac{A \times B}{C}$$
 - A= amount of interest, other than the amount of interest which is directly attributable to the exempt income stated in (a) above.
 - B= The average 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 relevant accounting year.
 - C= The average of the total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the relevant accounting year. The term "Total Assets" means 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.

- (c) An amount equal to ½% 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 relevant accounting year.

The Delhi Tribunal has taken the view in the case of Insaallah Investments Ltd. v/s ITO [23 SOT 130] by holding that the phrase ‘income which does not form part of total income’ used in s. 14A is not limited to only the cases where some income has actually been received. It will also apply to the cases, where income cannot be included in the total income whether received or not.

However Special Bench in the case of Cheminvest Ltd. Vs. I.T.O. 121 I.T.D. 318 decided this issue against the assessee.

The only controversy before the special bench was whether disallowance u/s 14A could be made where no dividend is received in the year under consideration. In this case the assessee had borrowed monies for acquiring shares as a trader as well as an investor but no dividend was received in the concerned year. The contention of assessee was that since no income forming part of total income was received, the question of making any disallowance did not arise. After hearing the parties, it was held that if the expenditure is incurred in relation to income which does not form part of total income, it has to suffer disallowance irrespective of the fact whether any income is earned by the assessee or not. Section 14A does not envisage any such exception. When prior to introduction of section 14A, an expenditure both under sections 36 and 57 was allowable to an assessee without such requirement of earning or receipt of income, such condition cannot be imported when it comes for disallowance of the same expenditure u/s 14A. In coming to this conclusion, the bench relied on the decision of the Hon’ble Supreme Court in the

case of CIT vs Rajendra Prasad Moody 115 ITR 519 SC.

However, CBDT vide its circular No.5/2014, dated 11/02/2014 clarified that Rule 8D of the rules read with Section 14A of the Act provides for disallowance of the expenditure incurred in relation to the exempt incomes even where the taxpayer in a particular year has not earned any exempt income. It is pertinent to note that none of the High Court has considered the CBDT Circular No.5/2014.

View in Favour the Proposition:

CIT vs. Corrttech Energy (P.) Ltd. 223 Taxman 130 (Guj)(HC)

Counsel for the Revenue submitted that the Assessing Officer as well as CIT (Appeals) had applied formula of rule 8D of the Income Tax Rules, since this case arose after the assessment year 2009-2010. Since in the present case, we are concerned with the assessment year 2009-2010, such formula was correctly applied by the Revenue. We however, notice that sub-section(1) of section 14A provides that for the purpose of computing total income under chapter IV of the Act, 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 Act. In the present case, the tribunal has recorded the finding of fact that the assessee did not make any claim for exemption of any income from payment of tax. It was on this basis that the tribunal held that disallowance under section 14A of the Act could not be made. In the process tribunal relied on the decision of Division Bench of Punjab and Haryana High Court in case of CIT v Winsome Textile Industries Ltd. [2009] 319 ITR 204 in which also the Court had observed as under :

“We do not find any merit in this submission. The judgement of this court in Abhishek Industries Ltd (2006) 286 ITR 1 was on the issue of allowability of interest paid on loans given to sister concerns, without interest. It was held that deduction for interest was permissible when loan was taken for business purpose and not for diverting the same to sister concern without having nexus with the

business. The observations made therein have to be read in that context. In the present case, admittedly the assessee did not make any claim for exemption. In such a situation section 14A could have no application.”

We do not find any question of law arising, Tax Appeal is therefore dismissed.

CIT vs. Shivam Motors Pvt. Ltd. in ITA No. 88 of 2014. (All)(HC)

“As regards the second question, Section 14A of the Act provides that for the purposes of computing the total income under the 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 the Act. Hence, what Section 14A provides is that if there is any income which does not form part of the income under the Act, the expenditure which is incurred for earning the income is not an allowable deduction. For the year in question, the finding of fact is that the assessee had not earned any tax free income. Hence, in the absence of any tax free income, the corresponding expenditure could not be worked out for disallowance. The view of the CIT(A), which has been affirmed by the Tribunal, hence does not give rise to any substantial question of law. Hence, the deletion of the disallowance of Rs.2,03,752/- made by the Assessing Officer was in order.

In CIT Vs. Rajendra Prasad Moody 115 ITR 522 it was held that Section 14 comes in to play only when the income received or receivable does not form part of total income and not otherwise.

Disallowance cannot be made if there is no exempt income or if there is a possibility of the gains on transfer of the shares being taxable.[CIT .v. Holcim India P.Ltd.(2014) 272 CTR 282(Delhi)(HC)]

Unless and until, there is receipt of exempted income for concerned assessment years, section 14A cannot be invoked. [CIT v lakhani Marketing Inc. [2014] 49 taxmann.com 257 (Punjab & Haryana)]

Also, CIT vs. Winsome textiles Industries Ltd. 319 ITR 204 (P&H)

Disallowance cannot be made if there is no exempt income. Cheminvest Ltd. Vs. ITO 121 ITD 318 (Ahd.)(SB) is not good law.

[Alliance Infrastructure Projects Pvt. Ltd. V. DCIT (Bang.)(Trib.)]

No disallowance can be made if there is no exempt income-Special bench judgement in Cheminvest& CBDT Circular 5/2014 are not good law

[ACIT .v. M. Baskaran (Chennai)(Trib.) I.T.A No. 1717/Mds/2013]

In the absence of establishment of clear cut nexus between the amount advanced to sister concerns and the interest incurred on borrowed amounts, disallowance of notional interest on ground of non utilization for purpose of business is not justified. [SSPDL Ltd. V. DCIT (2013) 59 SOT 68(URO)(Hyd.)(Trib.)]

Onus is on AO to show how assessee’s claim is incorrect. AO has to show direct nexus between expenditure & exempt income. Disallowance cannot be made on presumption. [DCIT v. Allied Investment housing P. Ltd.]

Summation:

Section 14A(1) provides that 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. Thus section 14A applies if

- i) The assessee has earned the income in the relevant assessment year which does not form part of the total income (exempt income); and
- ii) The assessee has incurred expenditure in relation to such taxable income; and
- iii) Such expenditure is incurred also in relation to exempt income; and
- iv) But for section 14A, it is not permissible to apportion such expenditure between the taxable and exempt income and as a result the whole of such expenditure is allowable against the taxable income as provided in the other provisions of the Act.

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Section 14A provides that even in such cases the Assessing Officer is bound to apportion such expenditure between the taxable and exempt income on a reasonable and rational basis or method consistent with all the relevant facts and circumstances.

Exempt income

The first and foremost condition for applicability of section 14A is that in the relevant assessment year, the assessee has earned income which does not form part of the total income (exempt income). The basic condition for applicability of section 14A is that there should be the expenditure and the exempt income. In the absence of such nexus the provisions of section 14A will not be applicable. This presupposes the existence of exempt income. Therefore, in the absence of exempt income earned by the assessee the provisions of section 14A will not be applicable. Secondly, accrual of exempt income is essential for computation of such exempt income. In the absence of such accrual of exempt income there would be no question of computation of such exempt income and as a result no question of apportionment of expenditure between taxable income and exempt income. Thus in the absence of accrual of exempt income there would be no nexus between the exempt income and the expenditure and as a result section 14A will not be applicable in such a case. Thus, when the company has not declared the dividend there would be no exempt income and therefore the provisions of section 14A will not be applicable. In particular when the company is prohibited from declaring dividend there would be no accrual of dividend income and the provisions of section 14A cannot be applied.

Let me now refer to some important decisions where it has been held that if there is no exempt income earned during the relevant assessment year then no disallowance can be made u/s 14A.

(i) **CIT vs Shivam Motors Pvt Ltd ITA No.88/2014, (Order dt.05.05.2014) the Allahabad High Court** has held that “As regards the second question, Section 14A of the Act provides that for the purposes of computing the

total income under the 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 the Act. Hence, what Section 14A provides is that if there is any income which does not form part of the income under the Act, the expenditure which is incurred for earning the income is not an allowable deduction. For the year in question, the finding of fact is that the assessee had not earned any tax free income. Hence, in the absence of any tax free income, the corresponding expenditure could not be worked out for disallowance. The view of the CIT (A), which has been affirmed by the Tribunal, hence does not give rise to any substantial question of law.”

- (ii) **CIT vs Corrttech Energy Pvt Ltd [2014] 45 taxmann.com 116: The Gujarat High Court** has held that where assessee has not sought any exempt income, there cannot be any expense to be disallowed.
- (iii) **CIT vs Lakhani Marketing, ITA No.970/2008 (Order dt.02.04.2014), the Punjab and Haryana High Court** has held that when there was no dividend income and in such a situation, provisions of Section 14A of the Act has no applicability.
- (iv) **CIT vs Delite Enterprises ITA No.110/2009, the Bombay High Court** on an issue Whether on the facts and in the circumstance of the case and in law the Hon’ble Tribunal was right in deleting the disallowance made by the Assessing Officer of interest paid by the Assessee Company on borrowed funds amounting to Rs.241.10 lakhs overlooking the fact that the borrowed funds were used by the Assessee Company to invest in the Capital of another Partnership Firm and since profits derived by the Assessee Company from a Partnership firm were exempt from tax u/ s.10(2A) of the Income-tax Act, the interest expense related to such tax free profits is to be disallowed u/s.14A of the Income Tax Act? It

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has been held that we find that there is no profit for the relevant assessment year. Hence the question as framed would not arise.

- (v) **Alliance Infrastructure Project Pvt Ltd vs DCIT ITA Nos.220 & 1043 (Bang)/2013, (Order dated 12.09.2014) the ITAT Bangalore**, relying on the decisions of above High Courts has held that “unless and until, there is receipt of exempted income for the concerned assessment years, we are of the view, Section 14A of the Act cannot be invoked”.
- (vi) In the case of **CIT v. Holcim India P. Ltd ITA No. 486/2014 & 299/2014, Delhi High Court** held that S. 14A & Rule 8D disallowance cannot be made if there is no exempt income or **if there is a possibility of the gains on transfer of the shares being taxable**. HC has held that Income exempt under Section 10 in a particular assessment year, may not have been exempt earlier and can become taxable in future years. Further, whether income earned in a subsequent year would or would not be taxable, may depend upon the nature of transaction entered into in the subsequent assessment year. For example, long term capital gain on sale of shares is presently not taxable

where security transaction tax has been paid, but a private sale of shares in an off market transaction attracts capital gains tax. It is an undisputed position that assessee is an investment company and had invested by purchasing a substantial number of shares and thereby securing right to management. Possibility of sale of shares by private placement etc. cannot be ruled out and is not an improbability. Dividend may or may not be declared. Dividend is declared by the company and strictly in legal sense, a shareholder has no control and cannot insist on payment of dividend. When declared, it is subjected to dividend distribution tax.

- (vii) **In the case of Minda Sai Limited v. ITO (ITA No. 2974/Del/13), ITAT Delhi has been held that in the absence of exempt income, s.14A disallowance cannot be added to s. 115JB book profits even if assessee has accepted s. 14A disallowance in the normal computation.**

Finally it is submitted that law appears to be well settled that if no exempt income is earned then there is no question of any disallowance u/s 14A of the Income Tax Act, 1961.
