

A Fresh Look on Disallowance of Expenditure under Section 14A of the Income-tax Act, 1961 Read with Rule 8D (Along with Recent Judicial Decisions)



Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Income-tax Act, 1961. There have been cases, where deductions have been claimed in respect of such exempt income, which is against the basic principal of taxation. Section 14A was thus introduced to reject the claims of expenses in relation to earning of exempt income. The Section has been a subject matter of much debate and litigation issues since its introduction. This article aims to provide the readers a brief analysis of the provisions of this Section and the corresponding Rule 8D. It also discusses various judicial decisions on the subject which will help the assesses to substantiate their views before the assessing authorities. Read on...

Legislative History

Section 14A titled as “expenditure incurred in relation to income not includible in total income” has been inserted in Chapter IV of the Income-tax Act, 1961 by the Finance Act, 2001, with retrospective effect from 1st April 1962. This Section was amended by the Finance Act 2006, i.e. with effect from 1st April 2007, empowering the Central Board of Direct Taxes (CBDT) to prescribe rules for determination of the amount of disallowance under this Section. Rule 8D has accordingly been notified by the CBDT.

The reasons for making amendment in Section 14A were explained in para 11.1 to 11.3 of the CBDT Circular No. 14/2006 dated 28-12-2006. As per this Circular, the legislature has clarified that the intention of insertion of sub-Sections (2) and (3) was to provide

a method for computing the expenditure incurred in relation to earnings of the exempt income, which was missing in the erstwhile Section 14A.

Also as per a recent Circular No-5/2014 dated 11.02.2014, CBDT has clarified that Section 14A read with Rule 8D can disallow the expenditure in relation to exempt income even where taxpayer, in a particular year, has not earned any exempt income.

As per the Circular, the legislative intent is to allow only that expenditure which is relatable to the earning of income and it, therefore follows that the expenses which are relatable to earning of exempt income have to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial year or not.

Provisions of Section 14A

Before understanding the analogy of Section 14A, let us go through the provisions of Section 14A as appearing in the Act:

“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



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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 AO, 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.”

The reading of sub-Section (1) of Section 14A makes it amply clear that no deduction shall be allowed in respect of expenditure which has been incurred in earning exempt income. Sub-Section (2) empowers the Assessing Officer to determine the amount of expenditure which is attributable to the earning of exempt income as per the method prescribed, if the Assessing Officer is not satisfied with the claim of assessee. Further sub-Section (3) clarifies that the provision of sub-Section (2) would even apply in the cases where an assessee contends that he has not incurred any expenditure in relation to the earning of exempt income.

In exercise of the powers given under Section 14A(2), CBDT *vide* Notification No. S.O. 47(E) on 24-3-2008 (299 ITR (ST) 88) had amended the Income-tax Rules by insertion of a new Rule 8D so as to prescribe the method for determination of expenditure in relation to income not includible in total income.

Rule-8D “Method for determining amount of expenditure in relation to income not includible in total income” reads as under-

- (1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with—
- (a) Correctness of the claim of expenditure made by the assessee; or

- (b) 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 direct expenditure* relating to income which does not form part of total income;
- (ii) *expenditure by way of interest* (in cases where the assessee has incurred any 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 :—

$$A*B/C$$

where,

A = amount of expenditure by way of interest other than the amount of interest included in (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 and last day of the previous year

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

- (iii) *an amount equal to ½% of 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 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.”

Therefore, for the purpose of Section 14A(1), the computation of disallowance has to be made as per Rule 8D (2) and (3) aggregating the following:

Step 1— The direct expenditure relating to income which does not form part of total income.

Step 2— The interest expenditure (other than those included in Part-1) in proportion of average investment to average asset.

Step 3– The expenditure on presumptive basis which is 0.5% of average investment.

Note: For the purpose of ‘Investment’ in Step 2 and 3, only those investments should be considered which are capable of giving rise to exempt income. In short, investments such as bank deposits, bonds, *etc.* which would give rise to non-exempt income should be ignored.

Objectives of Section 14A

Section 14A was introduced to cover up cases where expenses in relation to income such as agricultural income, tax free bonds, *etc.* which did not undergo any tax under the Income-tax Act, was being claimed.

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 exemption 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 which is against the basic principle of taxation where only net income is taxed. *It was only to reject such claim, this provision was introduced.*

Recent Judicial Decisions Relating to Section 14A

1. **Issue: No disallowance can be made if no exempt income has been received during the year.**

Decided Case Law:

CIT vs. Lakhani Marketing Incl.

Punjab & Haryana High Court, I.T.A No-970 of 2008

Dated-02.04.2014

Facts: Assessee has not received any tax free income during the year under consideration although he was holding securities capable of earning the tax free income.

Decision: Held that, while invoking disallowance under Section 14A read with Rule 8D, following points are to be kept in mind:

- That there must be income which is taxable under the Act;
- That this income must not form part of total income under the Act;
- That there must be an expenditure incurred by the Assessee; and
- That the expenditure must have a relation to the income which does not form part of the

total income under the Act.

Therefore, unless and until there is receipt of exempted income for the concerned assessment year, Section 14A of the Act cannot be invoked.

Similar view has been taken in the case of *Commissioner of Income Tax vs. M/s Shivam Motors Pvt. Ltd., High Court (Allahabad), I.T.A No-88 of 2014 Dated- 05.05.2014.*

2. **Issue: No Disallowance under Section 14A/ Rule 8D if interest income exceeds interest expenditure.**

Decided Case Law:

ITO vs. Karnavati Petrochem Pvt. Ltd.

ITAT (Ahmedabad), I.T.A.No-2228/AHD/2012

Dated- 05.07.2013

Facts: During the course of assessment proceedings, the Assessing Officer noticed that the assessee has made investment in shares amounting to ₹95,45,400/-. The Assessing Officer was of the view that the investment would generate exempt income and therefore, provision of Section 14A becomes applicable. He accordingly, applying the formula prescribed in Rule 8D of Income Tax Rules, worked out disallowance under Section 14A of ₹15,63,883/-.

Decision: CIT(A) while granting relief to the assessee, has given a finding that no nexus has been established by the AO with the amount incurred by the assessee for earning the tax free income. He has further noted that in the assessee's case, the interest income was more than interest expense and thus the assessee was having net positive interest income and therefore, the same cannot be considered for disallowance and for which he placed reliance on the decision of the Kolkata Tribunal in the case of *Trading Apartment Limited* and the decision of the Tribunal in the case *Morgan Stanley India Securities Private Limited*. He however considered the administrative expenses to be 0.5% of the average investments and disallowed the same.

3. **Issue: Investments made by the assessee in its subsidiary are not be reckoned for disallowance under Section 14A read with Rule 8D.**

Decided Case Law:

EIH Associated Hotels Ltd vs. DCIT

ITAT Chennai, I.T.A. No. 1503/Madras/2012

Dated-17.07.2013

Facts: **The** Assessing Officer has made disallowance to the tune of ₹4,32,66,500/-. The contention of the assessee is that the assessee

has earned dividend income of ₹4.6 lakh which is fully exempt under Section 10(34) of the Act. The assessee has made voluntarily disallowance of ₹45,927/- under Section 14A. The assessee has made fresh investments to the tune of ₹9.4 crore during the year. The Assessing Officer held that the investments have been made from the fresh secured loans obtained during the year by the assessee. The CIT(A) after going through the submissions made by the parties has come to the conclusion that the assessee has made investments from its own funds except for the short term investments made in HDFC Cash Management Fund and DSPML Cash Plus Fund in respect of which the amounts were invested from interest bearing funds borrowed from HSBC. The Revenue has not been able to controvert the findings of CIT(A).

Decision: Held that, the investments made by the assessee in the subsidiary company are not on account of investment for earning capital gains or dividend income. Such investments have been made by the assessee to promote a subsidiary company into the hotel industry. A perusal of the order of the CIT(A) shows that out of a total investment of ₹64,18,19,775/, ₹63,31,25,715/- is invested in wholly owned subsidiary. This fact supports the case of the assessee that the assessee is not into the business of investment and the investments made by the assessee are on account of business expediency. Any dividend earned by the assessee from investment in subsidiary company is purely incidental. Therefore, the investments made by the assessee in its subsidiary are not to be reckoned for disallowance under Section 14A read with Rule 8D. The Assessing Officer is directed to recompute the average value of investment under the provisions of Rule 8D after deleting investments made by the assessee in subsidiary company.

4. Issue: Dissatisfaction of Assessing Officer is a pre-requisite for invoking provisions of Section 14A read with Rule 8D.

Decided Case Law

Kalyani Steels Ltd. vs. Addl. Commissioner of Income Tax

ITAT Pune, I.T.A No-1733/PN/2012

Dated-30.01.2014

Facts: In this case, the assessee has earned by way of dividends a sum of ₹5,45,58,685/, which is exempt under Section 10(34) of the Act and thus the same does not form part

of the total income under the Act. In the computation of income, the assessee having regard to Section 14A of the Act, determined the amount of expenditure incurred in relation to such income at ₹5,00,000/-. The AO has not found it acceptable and has instead determined the amount of expenditure in relation to such income by applying Rule 8D of the Rules.

Decision: The Tribunal has found that no reasons have been recorded as to why the disallowance determined by the assessee was found to be incorrect, having regard to the accounts of the assessee. The only point made by the Assessing Officer is to the effect that “the said disallowance was not acceptable”. In fact, the Tribunal finds that the assessee made detailed submissions to the Assessing Officer, which have been reproduced by the CIT (A) in his order. The points raised by the assessee have not been addressed by the AO and the same have been brushed aside by making a **bland statement that the disallowance is “not acceptable”**.

Therefore, in the present case, the Assessing Officer has not recorded any objective satisfaction in regard to the correctness of the claim of the assessee, which is mandatorily required in terms of Section 14A(2) of the Act and therefore, his action of invoking Rule 8D to compute the impugned disallowance is untenable. Accordingly, the orders of the authorities below are set-aside on this aspect and the Assessing Officer is directed to retain the disallowance under Section 14A of the Act to the extent of ₹5,00,000/-, as returned by the assessee. Similar decision has been pronounced in the case of *DCIT vs. Ashish Jhunjhunwala, ITAT (Kol), I.T.A. No-1809/Kol/2012, dated-14.05.2013*.

5. Issue: Rule 8D(2) (ii) and (iii) not apply to shares held as stock-in-trade while Section 14A still applies.

Decided Case Law

Deputy Commissioner of Income Tax vs. Gulshan Investment Co. Ltd

ITAT Kolkata, I.T.A No-666(Kol) of 2012

Dated-11.03.2013

Facts: The Assessee is engaged in the business of share trading. During the course of scrutiny assessment proceedings, the Assessing Officer noticed that while the assessee has earned dividend income of ₹18,91,556, the assessee has not made any disallowance under Section 14A in respect of “expenses relatable to the above exempt income”. The AO also noticed that the assessee had paid

interest of ₹10,34,315. On these facts, the AO computed the disallowance under Section 14A read with Rule 8 D as follows:

Disallowance under Section 14A:

During the relevant year, the assessee had earned dividend income of ₹18,91,556/-. It was found that the expenses relating to the above exempt income has not been included back to the total income for taxation. Assessee paid interest for ₹10,34,315/-. As per step 2 of Rule 8D, ₹7,97,762/- is disallowed. As per step 3, disallowance worked out as under:-

Opening value of stock-in-trade	₹20,17,95,911
Closing value of stock-in-trade	₹33,72,25,080
Average stock-in-trade	₹26,95,10,496
½% of average stock-in-trade	₹13,47,552
Total addition under section. 14A	₹21,45,314
	(i.e. ₹13,47,552 + ₹7,97,762)

Decision: There cannot be any income without any kind of expenses or labour, howsoever small it may be. Section 14A is still applicable where it provides that no deduction in respect of expenditure incurred by the assessee in relation to exempted income will be allowed. Rule 8D is a method prescribed when the dividend income is earned from investments. Therefore, in the facts and circumstances of the case of the assessee, the expenditure is estimated to be @10% of the dividend earned, as fair and reasonable estimation. Therefore, an expenditure of ₹1,89,155/- is disallowed in addition to an amount of ₹1,57,227/- as disallowance under Section 94(7) in relation of earning of dividend income.

A plain look at the Rule shows that 8D(2)(ii) and (iii) can only be applied in the situations in which shares are held as investments, and that this rule will not have any application when the shares are held as stock in trade. In other words, in a case where shares are held as stock in trade and not as investments, the disallowance even under Rule 8D is restricted to the expenditure directly relating to earning of exempt income. Consequently, while Section 14A will still apply in the cases whether shares are held as stock in trade or as investments. Therefore, disallowance under Section 14A can be to the tune of ₹1,89,155 only.

6. Issue: Interest expenditure cannot be disallowed by mechanically applying (without establishing nexus between the interest bearing borrowed

fund and investment yielding exempt income) provisions of Rule 8D

Decided Case Law

REI Agro Ltd. vs. DCIT

ITAT (Kolkata), I.T.A No-1331/Kol/2011

Dated-19.06.2013

Facts: There is no linkage or nexus between the funds borrowed by assessee and the impugned investments, still interest expenditure has been disallowed by mechanically applying the provisions of Rule 8D.

Decision: Neither the AO nor the CIT(A) has recorded any finding that having regard to the account of the assessee, they are not satisfied with the correctness of the claim of expenditure made by assessee or the claim made by assessee that no expenditure has been incurred in relation to income which do not form part of the total income under the Act for the relevant assessment year. In the absence of any such finding, facts of the present case shows that the investment in shares was made out of own capital employed and not from borrowed funds, no disallowance on account of interest expenditure can be made by invoking Rule 8D of the Rules. Accordingly, in the given facts and circumstances, we delete the addition and allow this issue of assessee's appeal.

Conclusions

As per the above case laws, the following conclusions can be drawn:

1. Section 14A is applicable on all types of investments, whether held as stock-in-trade (SIT) or held as investments.
2. Disallowance under Section 14A can be made only if tax free income has been received during the year. However, CBDT Circular No.5/2014[F. No.225/182/2013-ITA.II], dated 11.02.2014 says that expenses which are relating to earning of exempt income has to be considered for disallowance, irrespective of the fact whether any such income has been earned during the financial year or not.
3. In order to invoke provisions of Section 14A read with Rule 8D, nexus has to be established between interest bearing borrowed funds and investment in securities providing tax free income.
4. Provisions of Section 14A read with Rule 8D can be invoked only if dissatisfaction has been recorded by the Assessing Officer.
5. Dividend received from investment made in subsidiary company is only incidental to the investment and no disallowance can be invoked. ■