SECTION 14A r.w. Rule 8D - A DETAILED ANALYSIS

by

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I. INTRODUCTION

A bare look at the Finance Bill reveals that some amendments are proposed with a retrospective effect, i.e. they shall have effect from the date of enactment of such provision. The competence of the legislature to enact or amend the law with retrospective effect is not in question but such power was exercised rarely. It used to be an exception. But looking at the scenario today, retrospective amendments are being enacted to invalidate the consequence of judicial decisions given by various courts and tribunals. Retrospective amendments are proposed in the nature of clarificatory amendments, which mean that they help one understand why a particular provision was introduced by the legislature and the nature and scope of the same. One fine example for the same can be the introduction of Section 14A.

Section 14A was introduced in the year 2001 to clarify the intention of the legislature with respect to expenses relating to earning of an exempted income. This was passed after the Supreme Court decision in **Rajasthan Warehousing Corporation [242 ITR 450 (2000)]**, where it was held that when an assessee had a composite and indivisible business which had elements of both taxable and non-taxable income, the entire expenditure in respect of the said business was deductible and, in such a case, the principle of apportionment of the expenditure relating to the non-taxable income did not apply. However, where the business was divisible, the principle of apportionment of the expenditure was applicable and the expenditure apportioned to the 'exempt' income or income not eligible to tax, was not allowable as a deduction.

II. INTENTION

The intention of the legislature in introducing Section 14A can be traced in the language used in the said provision and also in the memorandum issued by the Finance Ministry along with it.

Certain incomes are not included while computing the total income as these are exempt under various provisions of the Finance Act. There are cases where expenses have been claimed in respect of such exempt income, which 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. Expenses incurred can be allowed only to the extent they are relatable to the earning of such income. Section 14A was, therefore introduced with effect from 1st April 1962 so as to clarify that this was the said intention of the legislature from the inception of the Income Tax Act. However, to set the existing controversy on this issue at rest and not to unsettle the cases by raising the issue afresh Circular No. 14 of 2001 was introduced (paragraph 25 of the circular, is relevant. The aforesaid Circular No.14 provides Explanatory Notes on the provisions of Finance Act, 2001, relating to direct taxes, **refer 252 I.T.R. (St) 65)**

III. NATURE AND SCOPE OF SECTION 14A

Section 14A has been introduced by the Finance Act of 2001 in Chapter IV and has effect from 1-4-1962. The said Section provides for disallowance of expenditure incurred in relation to income which is not included in the total income of the assessee (i.e. exempt income, for example agricultural income).

In other words, Section 14A deals with expenses incurred by an individual to earn an exempt income. Such expenses are not deductible from one's gross total income and are disallowed. Therefore, if expenses to earn such exempt incomes are shown in an assessee's income statement, then the tax authorities will disallow such expenses. This section applies only to such cases where expenses have been incurred to earn the exempt income. In **CIT Vs. Rajendra Prasad Moody 115 ITR 522** it was held that Section 14 comes

into play only when the income received or receivable does not form part of total income and not otherwise.

As per Section 14A, expenditure which has a bearing on exempt income should not be considered in the computation of total income as otherwise this would result in double advantage to the assessee. For example when agricultural income itself is exempt from taxation, there is no justification to consider expenditure on agricultural activities in the computation of total income. Similarly, there is no legitimacy for claiming deduction of interest on moneys borrowed for capital contribution in a partnership by a partner, since the share of profit from the firm is exempt from tax.

Similarly, say a company has borrowed a sum of say rupees two crores and pays an annual interest of say rupees two lakhs and at the same time has invested in the shares of another company for about rupees twenty thousand, in such a case the company would receive a dual benefit of 2 lakhs and on dividend on the twenty thousand.

IV. APPLICABILITY OF SECTION 14A

The following conditions have to be satisfied for the applicability of Section 14A.They are

1. Assessee must have exempted income which is not includable in his total income.
2. Assessee must have incurred expenditure in relation to earning of income which is exempted under Income Tax Act.
   2.1 Definition of the term expenditure and incurred
   2.2. A nexus between the income earned and the expense incurred.
3. Whether such income was earned in the specific year in question.

1. What is exempted income?

Exempted income can be said to be that income which does not form a part of the total income. The best example for exempted income can be agricultural income. Other exempted income can be the income listed in S. 10, S. 10A, S. 10AA, S. 10B, S. 10BA, S. 10C and such other incomes exempted from total income under this Act or any other Act, time being in force.

Below are some of the decisions where it was held that disallowance can be made u/s.14A in respect of income from agricultural income, dividend on shares or units of Mutual Fund, Share from Partnerships Firms, etc.

Agricultural Income falls as one of the exception under Section 10(1) - **Haryana Land Reclamation & Development Corp. Vs. CIT, [159 Taxman 271 (P & H)]** the court held that any expenditure for purchase of fertilizer etc towards the earning of such agricultural income shall be disallowed.

Shares and units of mutual funds are an exempted under Section 10(23) In, **Wallfort Shares & Stock Brokers Ltd. Vs. ITO, [96 ITD 1 (Mum.) (SB)]**, the court held that any expenditure towards the earning of such income shall be disallowed.
Other decisions **Harish Krishnakant Bhatt Vs. ITO, [91 ITD 311 (Ahd.)], DCIT Vs. S. G. Investments & Industries Ltd., [89 ITD 44 (Kol.)], Muruti Udyog Ltd. Vs. DCIT, [92 ITD 119 (Del.)], Shree Synthetics Ltd. Vs. CIT, [205 CTR 386 (MP)] Escorts Ltd. Vs. ACIT, [102 TTJ 522 (Del.)]**

Share in Profit from Firm are an exempted item under Section 10(2A) - **Sudhir Dattaram Patil Vs. DCIT, [2 SOT 678 (Mum.)]**, the court held that any expenditure towards the earning of such income shall be disallowed.

Other decisions **A. H. Baldota Vs. ACIT, [103 TTJ 517 (Mum.)], Marezban Bharucha Vs. ACIT, [12 SOT 133 (Mum.)]**

2. Assessee must have incurred expenditure in relation to earning of income which is exempted under Income Tax Act.

2.1. Definition of the term 'expenditure' and 'incurred'

The term 'expenditure' as used in the Section means what is paid out or away, something which is gone irretrievably. Expenditure means something that a trader pays out from his pocket.

Expense has many forms, namely, accrued expense, administrative expense, business expense, capital expense, current expense, deferred expense, educational expense, entertainment expense, extraordinary expense, fixed expense, general administrative expense, medical expense, moving expense, operating expense, ordinary and necessary expense, organizational expense, put-of-pocket expense, prepaid expense, travel expense. The term "expenditure" as mentioned in Section 14A would take within its ambit not only direct expenditure but also all forms of expenditure regardless of whether they are fixed, variable, direct, indirect, administrative, managerial or financial.

The term "incur" has been defined at page 771. Black's Law dictionary, 7th edition as follows: "incur, "To suffer or bring on oneself (a liability or expense)".

The phraseology used in Section 14A prohibiting the deduction in respect of expenditure incurred by the assessee in relation to exempt income is thus wide enough to cover all forms of expenses provided they have some connection with the exempt income. This is based on the principle that expenses must be allocated to that income to which they

are connected to circumvent falsifications in the calculation of both taxable as well as exempt income. The same was so held in **Asstt. Cit, Range 10(1) Vs. Citicorp Finance (India Ltd.) [2008 300 ITR 398 Mum]**

The Delhi High court in the case of **Maxopp Investment Ltd. Vs. CIT [TS-668-HC-2011(Del)]** observed, "While we agree that the expression 'expenditure incurred' refers to actual expenditure and not to some imagined expenditure, we would like to make it clear that the 'actual' expenditure that is in contemplation u/s 14A (1) of the Act is the actual expenditure in relation to or in connection with or pertaining to exempt income. The corollary to this is that if no expenditure is incurred in relation to the exempt income, no disallowance can be made u/s 14A of the said Act." A reference also was made to a similar finding by Punjab & Haryana High Court in the case of **CIT-II Vs. Hero Cycles Ltd.[(323 ITR 518)].** A similar view was taken in **Metalman Auto P Ltd. [(336 ITR 434]**

2.2 Nexus between the income earned and the expense occurred.

It is not sufficient if it is shown that there was an expense. It is necessary to establish that there is a nexus between the income earned and the expense occurred.

The following decisions support this statement

a) In **DCIT Vs. S.G. Investments and Industries the ITAT on 29 May, 2003**, clarified that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. The nature of expenses incurred by the assessee may, therefore, relate partly to the exempt income and partly to the taxable income, but the intention of the

legislature is to allow the expenses only to the extent they are relatable to the earning of taxable income.

b) In **Yatish Trading Co. P Ltd [(2011)129 ITD 237 (Mum)]** it was held that interest incurred for share trading activity could not be disallowed u/s 14A, as the earning of dividend was only incidental to the share trading activity. Simply because shares purchased for trading incidentally resulted in some dividend, it would not change the nature, character and purpose of the interest expenditure. In order to disallow expenditure u/s 14A, there must be a live nexus between the expenditure and earning of income which was not there in the present case.

c) In **CIT v Hero Cycles Limited [323 ITR 518]** the hon'ble court held that disallowance under section 14A was not permissible where there was no nexus between the expenditure incurred and the income generated.

d) Similar principles were upheld in **Godrej & Boyce Mfg. Co. Ltd. [(2010) 328 ITR 81 (Bom HC)], Everplus Securities and Finance Ltd Vs. DCIT [(2006)101 ITD 151]**
Justice Sam P Bharucha Vs. Addl. CIT in ITA No.3889/Mum/2011,Wallfort Shares & Stock Brokers Ltd- Vs.- I.T.O. 310 ITR 421 (Bom) and in CIT-Vs.- Smt. Leena Ramchandran (ITA No. 1784 of 2009—order dated14.6.2010).

3. Disallowance- whether such income was earned in the specific year in question.

If expenditure is incurred in relation to exempt income, such expense shall be disallowed whether or not such income was earned in the specific year in question

This principle was decided in **Cheminvest Ltd Vs. Income Tax Officer [124 TTJ 577 (Del)(SB)]** where the issue before the bench was whether disallowance under Section 14A could be made even in cases where no dividend income was received in the year under consideration. In this case the assessee had borrowed sums for purchasing shares in the dual capacity i.e.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 arguments of both the sides, 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 Sec 14A, an expenditure both under sections 36 and 57 was allowable to an assessee without the 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]**

Similar view was taken in, **I Technopack Advisors P Ltd [(2012) 50 SOT 31 (Delhi) (URO) and in Relaxo Footwear Ltd [(2012) 50 SOT 102 (Delhi)].**

Contrary views

Contrary views can be found in **Lafarge India Holding (P) Ltd Taxcorp Ltd. (ITAT) 17086.**The ITAT held that if no dividend income was earned during the year, there can be no disallowance under Section 14A

Gurdas Mann vs. DCIT (2013) 21 ITR (Trib) 57 where it was held that in the absence of any income earned by the assessee, which is exempt u/s. 14A there can be no disallowance of any part of the expenditure being relatable to such exempt income, which in the case of the assessee is nil—AO is directed to delete the same

V. METHOD OF COMPUTING DISALLOWANCE

1. Prior to the introduction of Rule 8D
2. Introduction of Rule 8D
    - 2.1. Expenditure-Direct or Indirect
    - 2.2. Borrowed Money Vs. Own Money
    - 2.3. Satisfaction of the AO

1.PRIOR TO THE INTRODUCTION OF RULE 8D

Prior to the introduction of Rule 8D there was no method in the statute book for computing the expenditure incurred for earning the exempted income. Each Officer applied his own method and there was no uniformity in the manner in which the disallowance was made.

The following decisions highlight some of the issues

a) Escorts Ltd. Vs. ACIT [2006] 102 TTJ 522 (Del.)

In this case, one of the issues before the Hon. Tribunal was disallowance under section14A in respect of dividend and interest income. In the instant case, the dividend income of Rs. 8.9 crore (approximately) and interest income of Rs.10.13 crores approximately are excludible from the purview of total income under the Act on account of sections 10(33) and 10(23G), respectively. According to the assessee, the investments in shares and mutual funds have been

predominantly made in the earlier years. The assessee does not have any dedicated set-up for the purposes of managing its investment portfolio. This activity is intermingled with its other activities. Not much activity is required in earning the dividend or the interest income once the investments have been made. Nevertheless, in the absence of separate accounts by way of which the management and administrative expenditure could be segregated, estimation is inevitable. The estimation was made by the AO on a thumb rule basis. The Assessing Officer has applied percentage in the proportion of the incomes earned for arriving at the related expenditure. Such an approach cannot be considered as reasonable inasmuch as it does not take into account the relevant factors.

b) Dhanlakshmi Bank Ltd. vs. ACIT [2007] 12 SOT 625 (Coch.)

In this case, the assessee bank had made investment in tax-free bonds as well as shares and earned interest-income and dividend income which were exempt under section 10 of the Act. The AO, by invoking the provisions of section14A, disallowed proportionate expenditure. It was held that since there was no clear identity in respect of funds applied by the assessee for making investment for earning tax-free income as well as taxable income and the assessee's business being an indivisible one, the method adopted by the AO for making the disallowance was not a permissible method.

c) Similar principles were held in **Wimco Seedlings Ltd. Vs. Dy. CIT (Asst.) [2007] 293ITR (AT) 216 (Del.) (TM) and Zuari Industries Ltd. Vs. ACIT [2007] 108 TTJ 140 (Mum.).**

2. Introduction of RULE 8D

Sub-sections (2) and (3) were inserted in section 14A by the Finance Act, 2006, with effect from 1.4.2007. Sub section 2 of Section 14A

makes it clear that the Assessing Officer shall determine the amount of expenditure w.r.t exempted income if he is not satisfied with the correctness of the claim. He shall do the same by the method prescribed after having regard to the accounts of the assessee .Sub section 3 provides that 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

In view of clauses 2 and 3 of Section 14A, Notification No. 45/2008, dated 24.03.2008 was introduced which has amended the Income-Tax Rules, 1962 and inserted a new rule i.e. Rule 8D which gives the method for determining amount of expenditure in relation to income not includible in total income.

The constitutional validity of both sub section 2 and 3 as well as Rule 8D has been upheld by the court in Godrej & Boyce Mfg Co. Ltd v DCIT 328 ITR 81 where it was held that Disallowance under section 14A has to be made in accordance with the principle laid down by the Hon'ble Bombay High Court in the present case. Further, Rule 8D should not be applied and the AO has to adopt a reasonable basis or method consistent with all relevant facts and circumstances and after affording reasonable opportunity to the assessee to place all germane material on the record. It was further held that:-

i) The provisions of sub sections (2) and (3) of Section 14A of the IncomeTax Act 1961 are constitutionally valid

ii) The provisions of Rule 8D of the Income Tax Rules as inserted by the Income Tax (Fifth Amendment) Rules 2008 are not ultra vires the provisions of Section 14A, more particularly sub section (2) and do not offend Article 14 of the Constitution

If one examines Rule 8D, we find that the method for determining the expenditure in relation to exempt income has three components.

i. Amount of expenditure directly relating to income which does not form part of the total income.
ii. Expenditure computed on the basis of the formula given therein in a case where the assessee incurs expenditure by way of interest which is not directly attributable to any particular income or receipt.
iii. An artificial figure - half percent of the average value of the investment, income from which does not or shall not form part of the total income.

The aggregate of these three components which would constitute the expenditure in relation to exempt income and it is this amount of expenditure which would be disallowed under section 14A.

2.1. Expenditure-Direct or Indirect

It is, clear that in terms of the said Rule, the amount of expenditure in relation to exempt income has two aspects – (a) direct and (b) indirect. The direct expenditure is straightaway taken into account by virtue of clause (i) of sub-rule (2) of Rule 8D. The indirect expenditure, where it is by way of interest, is computed through the principle of apportionment, as indicated above, and, in cases where the indirect expenditure is not by way of interest, a rule of thumb figure of one half percent of the average value of the investment is to be calculated. The Rule extends (besides interest) to disallowing other expenses or indirect expenses as was held in the case of **ITO Vs. Daga Capital Management Private limited (2008) 26 SOT 603 (Mum).**

Example

S NO	TYPE OF EXPINDITURE	OPENING BALANCE	CLOSING BALANCE	TOTAL/AVERAGE
1.	Direct Expenditure			0
2.	Expenditure by way of interest (A)			1,00,000
3.	Average value of investments (B)(on shares and MF)	8,00,000	12,00,000	10,00,000 (AVERAGE)
4.	Average of total assets (C)	48,00,000	52,00,000	50,00,000 (AVERAGE)
5.	An amount equal to one half of average value of investments	50,00,000	50,00,000	½ % of 50,00,000 = 25,000/-

Amount of disallowance for the year = 100000*(1000000/5000000)=20,000/-

To this figure of 20000, we need to also add 1/2% of the average total assets = ½ % of 5000000 = 25,000/-

The requirement of adopting a specific method of determining such

expenditure has been introduced by virtue of sub-section (2) of section 14A Therefore total disallowance under Section 14A = 20,000+25,000=Rs. 45,000/-.

2.2. Borrowed Money Vs. Own Money

Can an Assessee claim that investments have been made entirely from Owned Funds, which are non-interest bearing and hence no disallowance u/s 14A is justified? Is mere presence of Owned Funds in excess of Investments on the Balance Sheet enough or does a direct nexus between investments and interest free funds needs to be proved? On whom does the onus of proof lie?

Decisions in favour of the Assessee

a) The Supreme Court in **Munjal Sales Corporation 298 ITR 298 held that** where the opening balance of profits of the firm exceeds the loans given to sister concerns, then it is presumed that the said loans are given out of its own funds.

b) The Madras High Court in **Hotel Savera Vs. CIT 239 ITR 796(mad),** held that where sufficient own funds of the assessee were available for making investment, it cannot be assumed that any part of investment producing the tax free income must have been from borrowed funds unless there is evidence to show that any specific investment has been made from borrowed funds.

c) The Bombay High Court in **Reliance Utilities and Power Ltd. 313 ITR 340** held that if interest free funds are 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.

d) **Similar view was taken in Maruti Udyog Ltd 92 ITD 119 , Godrej Industries Ltd. (ITA no. 1090 /Mum / 09) Hero Cycles Ltd. 323 ITR 518, Faze Three Exports Ltd. v. Add. CIT (ITA no. 7701/Mum/2004, Bunge Agribusiness (India) (P) Ltd. v. Dy. CIT (2011) 64 DTR 201 Britannia Industries 280 ITR 525, Godrej Agrovet Ltd. (ITA no. 1629/Mum/09), Ultramarine & Pigments Ltd [TS-786-ITAT-2011(Mum)]**

All these decisions followed the principle laid down by the Supreme Court in East India Pharmaceutical Works 224 ITR 627 (decision prior to introduction of Section 14A)

Against

a)The Mumbai Tribunal in **Daga Capital Management Pvt. Ltd. 26 SOT 603** held that all disallowances u/s 14A ought to be strictly computed as per Rule 8D irrespective of the fact whether interest free funds are available or not.

b) The Bombay High Court in **Godrej & Boyce Manufacturing Company Ltd. 234 CTR 1** held that

- The judgment in Reliance Utilities shows that there were interest free owned funds available and not merely reserves.
- The real enquiry is whether there are interest free funds available on the assets side and in the absence of sufficient proof of available interest free funds; no such presumption can be drawn.

- Moreover, it has been urged that after the introduction of Section 14A (1), no such presumption can in any event be drawn, since Parliament expressly requires apportionment

In this connection we need to look at Section 36(1) (iii)

Section 36 provides for deductions while computing income under Section 28.Section 36(1)(iii) provides for the deduction in the amount of interest paid in respect of capital borrowed for the purpose of business or profession. The primary condition for allowing deduction of interest in the computation of business income is that the interest was paid on capital borrowed for the purpose of business or profession. If the borrowed capital is utilized not in the business or profession, but is used for earning some exempt income, the interest paid, is not allowable deduction under the provision of Section 36(1) (iii). This analogy flows from Section 14A which states that only expenditure which is relatable to taxable income should be deducted in computing the total income.

Hence, expenditure which is incurred to earn exempt income should not be considered in the computation of total income as it would result in double advantage to the assessee. In **Avshesh Mercantile P. Ltd. and Ors ITA No. 6194/Mum/2006** (assessees or the Company), the Income-tax Appellate Tribunal, Mumbai Bench held that expenditure incurred by assessees to make any investment which is capable of earning taxable as well as exempt income (even though the same was actually not earned by assessees) cannot not attract disallowance under section 14A.In **Delite Enterprise Income Tax Appeal No. 110 of 2009** it was held that if the investment had the potential of generating taxable income in the form of short term capital gains etc., it is immaterial

whether such taxable income was earned in the year under consideration or not.

The mere possibility of an investment having the potential of earning taxable income was adequate to rule that disallowance u/s 14A could not be made.

2.3. Satisfaction of the AO

The AO cannot straight away resort to Rule 8D. Sub-Section 2 of Section 14A and Rule 8D(1), both require the AO to first consider the books of accounts of the taxpayer before resorting to Rule 8D. The AO must arrive at an objective satisfaction that the Assessee's claim is incorrect. In the case of Auchtel Products Ltd it was held by the Tribunal in Para 15 that disallowance u/s.14A is called for when the AO is not satisfied with the assessee's claim of having incurred no expenditure or some amount of expenditure in relation to exempt income. Satisfaction of the AO as to the incorrect claim made by the assessee in this regard is sine qua non for invoking the applicability of Rule 8D. Such satisfaction can be reached and recorded only when the claim of the assessee is verified. If the assessee proves before the AO that it incurred a particular expenditure in respect of earning the exempt income and the AO gets satisfied, then there is no requirement to still proceed with the computation of amount disallowable as per Rule 8D.

When the AO does not accept the assessee's claim regarding the non-applicability/ quantum of disallowance u/s 14A, he has to record satisfaction on that issue. This satisfaction cannot be a plain satisfaction or a simple note. It has is to be done with regard to the accounts of the assessee. On facts, as there is no satisfaction by the AO, no disallowance u/s 14A can be made .This was upheld in

Balarampur Chini Mills 140 TTJ (Kol) 73 and also REI Agro Ltd vs. DCIT , june 24th 2013

The Bombay High Court in **Godrej & Boyce Manufacturing Company Ltd. 234 CTR 1** has held that for objective satisfaction, following would be required from the AO:

a) Notice by the AO to the Assessee to present his facts and justify his claim
b) Recording of his reasons for arriving at a conclusion that the Assessee's claim is not justified.

Similar views were also expressed by the Coordinate Benches in the case of **Relaxo Footwears Ltd, Vs. Addl. CIT (2012) 50 SOT 102 , Priya Exhibitors (P)Ltd Vs.. ACIT (2012) 54 SOT 356, Godrej & Boyce Mfg. Co. Ltd. [(2010) 328 ITR 81 (Bom HC)], Delhi ITAT in the case of Jindal Photo Limited – ITA No.4539/Del./2010 dt 7 January 2011], Commissioner of Income Tax Vs. Hero Cycle Limited , Auchtel Products Ltd [TS-401-ITAT-2012(Mum)]**

VI. RULE 8D PROSPECTIVELY OR RETROSPECTIVELY?

Rule 8D was introduced on March 24, 2008 by CBDT vide Notification No. 45/2008, dated March 24, 2008 to take effect from AY 2008-09. It would be seen that sub-sections (2) and (3) of Sec 14A remained inoperative till A.Y.2008-09 because of the absence of any prescribed method for operation. Now the question arises on whether Rule 8D which was introduced in the year 2008, would have effect from the assessment year 2008-2009 or from the date of operation of Section 14A. Sub-section (2) of Section 14A remained an empty shell until the introduction of Rule 8D on 24.03.2008 which

gave content to the expression "such method as may be prescribed" appearing in Section 14A (2) of the said Act.

Now another question arises as to how Section 14A worked prior to the introduction of the said Rule 8D. Sub-section (2) of section 14A stipulates that the Assessing Officer shall determine the amount of expenditure incurred in relation to income which does not form part of the total income "in accordance with such method as may be prescribed". Of course, this determination can only be undertaken if the Assessing Officer is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. It is only the prescription with regard to the method of determining such expenditure which is new and which will operate prospectively. The same was upheld by the Supreme Court in **Walfort Vs. CIT [96 ITD 1 (Mum.) (SB)]**,

The operation of Rule 8D has been held to be prospective both by Bombay HC in the case of **Godrej & Boyce Mfg. Co. Ltd 234 CTR 1**. and Delhi HC in the case **of Maxopp Investment Ltd**. **203 Taxmann 364** Bombay HC observed in this regard, 'unless expressly or by necessary implication, or contrary provision is made, no retrospective effect is to be given to any rule so as to prejudicially affect the interests of the assessee. The Rules were notified to come into force on March 24, 2008. The same was upheld in **Continental Carriers P Ltd [(2011) 138 TTJ 249 (Delhi)] and in Wimco Seedlings limited v Dy CIT (Del) (TM) 96 ITD 1 (Mum.) (SB)]**,

The contrary view of the special bench in the case of **ITO Vs. Daga Capital Management Private limited (2008) 26 SOT 603 (Mum)** held Rule 8D being in the nature of procedural law are applicable retrospectively. The same was also upheld in In **ACIT v Citicorp Finance (India) Limited [300 ITR 398(AT Mum)]**

But after the Bombay High Court judgment in **Godrej & Boyce Manufacturing Company Ltd. 234 CTR 1** where it was clarified that Rule 8D would only have prospective effect from AY 2008-09 making it very clear that Rule 8D only has a prospective effect.

VII. APPLICABLILITY of Rule 8D TO PENDING MATTERS

Circular No. 11/2001 dated 23rd July, 2001, a direction was issued by the Central Board of Direct Taxes that the assessments where the proceedings have become final before the first day of April, 2001 should not be re-opened under Section 147 of the Act to disallow expenditure relatable to the exempt income by applying the provisions of Section 14A of the Act. Through Finance Act, 2002, a proviso to Section 14A has been inserted so as to clarify that the Assessing Officer shall not reassess the cases 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.

In **V Uppalaiah Vs. DCIT (2005)96TTJ (hyd) 706** and in **Paul John Delicious Cashew Co Vs ITO (2005)94 ITD 13**, the ITAT followed the above said circular No 11 of 2011 and held that reopening was invalid

VIII. WHETHER RULE 8D IS APPLICABLE IN CASE OF INVESTMENTS HELD AS STOCK-IN TRADE?

A moot question today is whether Rule 8D will be applicable to investments held as stock in trade, in case, during the year under consideration, the taxpayer had received dividend income from such investment. Now the question is whether while computing the disallowance under Rule 8D stock in trade should be taken into account

or not. There is no finality in regards to the said question. Various tribunals and courts have given different decisions in respect of the same question. A few of such decisions are extracted below

Decisions in favour

The Karnataka High Court (HC) **(ITA No. 359 of 2011 dt: 28 February 2012)** in the case of **CCI Ltd** held that when no expenditure is incurred by a taxpayer in earning dividend income, notional expenditure cannot be disallowed under Section 14A.The Section cannot be applied to disallow expenditure incurred on shares purchased for trading purposes from interest-free funds merely because such shares give rise to incidental exempt dividend income. The Karnataka HC, in this ruling, has taken a view in favor of taxpayer and held that the rigor of the Section cannot be applied to expenditure incurred on shares purchased for trading purposes merely because such shares give rise to incidental exempt dividend income. The same was also upheld by the Mumbai Tribunal in **ITO v. Daga Capital Management P. Ltd. [2009] 117 ITD 169 (Mum),** the Mumbai Tribunal in **Mukund Global Finance Ltd. v. DCIT20 SOT 825**

Decisions against

On a similar issue, the Delhi HC in the case of **Maxopp - 203 Taxmann 364** and Karnataka HC in the case of **Catholic Syrian Bank - 237 CTR 164,** the Bombay High Court **Godrej & Boyce Manufacturing Company Ltd. 234 CTR 1,** have held in favor of the Tax Authority. It was held that whether the shares are held as investments or as stock in trade will not have any impact on applicability of Section 14A so long as dividend income which does not form part of the total income under the Act is earned from the shares. These contra rulings do not appear to

have been cited or considered by Karnataka High Court in the case of CCI Ltd.

IX. SECTION 14A AND INSURANCE BUSINESS

Section 14A of the Income tax Act, 1961 is not applicable to an insurance business as they are governed under the specific provisions of section 44 of the Income Tax Act, 1961. This has been so decided by Pune ITAT in the case of **Bajaj Alliance General insurance Co. Ltd. Vs. Addl. CIT 38 Oriental Insurance Co. Ltd [130 TTJ 388 (Del.) (Trib.)]**.A Delhi bench of ITAT held that Sec 14A was not applicable to insurance companies. ITAT observed that the income of the insurance companies had to be computed u/s 44 read with Rule 5 of the First Schedule to Income Tax Act, which is a specific provision overriding Sec 14A. Since, as per Sec 44 no head-wise bifurcation of income was required to be made in case of insurance companies, Sec 14A disallowance could not be made. ITAT observed, "It is not permissible to the Assessing Officer to travel beyond s. 44 and First Schedule of the Income-tax Act."Also upheld by the Mumbai Tribunal in **Birla Sunlife Insurance Co. Ltd [TS-23-ITAT-2010(Mum)]**

X. SECTION 14A AND SECTION 57

In the new Section 14A of the Act, the language "expenditure incurred in relation to income which does not form part of the total income under the Act" appears to have wider implications as the word "In relation to income has a broader meaning than the word "for the purpose of making or earning income" used in Section 57(iii) of the Act. The word "in relation to" has not been defined under the Income Tax Act. It is to be understood in the context in which it is used. The Legislature was well aware that the expression "for the purpose of making or earning income"

used in Section 57(iii) has a narrower meaning. If the legislature had the intention to give a narrower implication to the newly inserted Section 14A as given to Section 57(iii), it would have used the similar expression for the purpose of computing total income under Chapter IV" no deduction shall be allowed in respect of expenditure incurred by the assessee wholly and exclusively for the purpose of making or earning income which does not form part of the total income under the Act" also in Section 14A of the Act. The expression "in the relation to" used by the legislature in newly inserted Section 14A of the Act is a broader expression having regard to the object behind the introduction of the provisions of Section 14A, which is inserted with an object (1) to disallow expenditure incurred in respect of exempt income against taxable income, (ii) to allow the expenses incurred only to the extent they are relatable to the earning of taxable income and (iii) to allow the exemption in respect of the net income. The expression "in relation to" used in Section 14A of the Act has both direct significance as well as indirect significance having regard to the context in which it is used.

XI. INVESTMENTS MADE IN FOREIGN COMPANIES

Section 14A(1) provides that 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. Section 10(33) exempts dividend referred to in section 115-O from the purview of taxation. Section 115-O talks of a 'domestic company'. Looking at the definition of a 'domestic company' u/s 2(22A) it means 'an Indian company or any other company which, in respect of its income liable to tax under this Act, has made the prescribed arrangement for the declaration and payment, within India, of the dividend (including dividends on preference shares) payable out of such income.' An examination of the term 'domestic company' , shows that it is only an Indian company, which in respect of its income is liable

to tax under this Act, has made prescribed arrangement for the declaration and payment of dividend making it very clear that the definition does not extend to foreign companies. It would therefore be seen that dividend declared by a foreign company is not covered under Section 10(34) and therefore is not an exempted income. It becomes apparent that the provisions of section 14A cannot extend to dividends received from investments made in the shares of foreign companies. The same was upheld in **2012-TIOL-453-ITAT-MUM** and in. **ITO Vs. Stides Acrolab Ltd 138 ITD 323 Mumbai ITAT.**

XII. SECTION 14A AND SECTION 80P

Section 14A states that for the purpose of computing total income under Chapter IV, no deduction shall be allowed in respect of expenditure incurred in relation to the income which does not form part of the total income under this Act. The words "do not form part of the total income under this Act" are significant and important. It makes it clear that it only applies to such scenarios where the income is not part of the total income and not to such cases where an income is part of the total income (acc to Section 4 read with Section5). Before allowing deduction under Chapter VIA we have to compute the total income. The income which qualifies for deductions under Sections 80C to 80U is to be first included in the total income of the assessee. Thereafter, deduction is to be allowed in accordance with and subject to the fulfillment of the conditions of the respective provisions under Chapter VIA. This is also subject to Section 80AB and 80A (1) and (2). Chapter VIA does not postulate or state that the incomes which qualify for the said deduction will be excluded and not form part of the total income. They form part of the total income but are allowed as a deduction and reduced. The distinction between the two, has been recognized in **Second Income Tax Officer and Another Vs. Stumpp Schuele and Somappa Private**

Limited, (1991) 187 ITR 108 (SC) where it was held that the deductions under Chapter VIA cannot be equated with incomes not included in the total income or which are not chargeable to tax. Chapter VIA in several provisions makes reference to net income as computed in accordance with the provisions of the Act

It has been uniformly and consistently held that in the absence of express language to the contrary, deduction if allowed does not mean that the said income ceases to be part of the total income.

Similar principles were upheld by the Supreme Court in **Distributors (Baroda) P. Ltd. v. Union of India** [**1985 (7) TMI 1 (SC)]** , **Cloth Traders P. Ltd. v. Addl. CIT [1979 (5) TMI 2 –(SC)**] **CIT v. South Indian Bank Ltd 1965 (11) TMI 40 – (SC), National Agricultural Cooperative Marketing Federation of India Ltd [TS-280-ITAT-2012(DEL)]** and the Delhi High Court in **Commissioner of Income-tax Versus Kribhco - 2012 (7) TMI 591**

XIII. SECTION 14A AND SEC 115JB

Another question lies before us on whether Section 14A will apply on computing book profit u/s 115JB.The Supreme Court in the **Apollo Tyres [255 ITR 273 (SC)**, held that the AO while computing income under section 115J has the power to examine whether the books of account were properly maintained in accordance with the Companies Act and further had limited power of making additions/deductions as provided for in the Explanation to the said section. But it should be noted that the AO does not have jurisdiction to go beyond the net profit shown in the Profit & Loss Account except to the extent provided in the Explanation to section 115JB of the Act and since the disallowance under the provisions of s. 14A of the Act is not covered by clauses mentioned in s. 115JB, no addition is warranted while computing book profits u/s/ 115JB

of the Act. Similar principles were upheld in **Quippo Telecom Infrastructure Ltd. Vs. ACIT I.T. A. No.4931/Del/2010**

XIV. PLANNING

- In order to avoid unreasonable and ad hoc disallowance by the Assessing Officer, the assessee can disallow in its computation of income, a reasonable amount of expenditure considering the following factors
- Quantum of investments made from which exempted income has been earned
- Quantum of dividend income received during the year
- Percentage of time spent and salary of an Administrative officer and any other manager for making such investments and earning of such income
- A Reasonable Disallowance by the assessee which cannot be found fault with by the Assessing Officer will ensure that rule 8D is not made applicable to the assessee and disallowance more prejudicial to the assessee is not made.

The Assessee can rely on the following decisions to support its claim

JK Investors Bombay Vs. ACIT ITAT Mumbai May 6, 2013

In AY 2008-09, the assessee had PMS investments in shares of Rs. 202 crores and other investments on which it earned dividends of Rs. 8.14 crores. The assessee claimed that the dividends were received only on a few scrips and computed s. 14A disallowance by identifying specific expenditure at Rs. 1.55 crores. The AO, without showing how the assessee's method was wrong, invoked Rule 8D and made a disallowance of Rs. 2.39 crores. On Appeal the tribunal held that the condition precedent for the AO to invoke Rule 8D is that he first must

examine the accounts of assessee and then record by giving cogent reasons why he is not satisfied with the correctness of the assessee's claim. In the absence of an examination of accounts and the recording of satisfaction, Rule 8D cannot be invoked. On facts, the assessee had itself disallowed interest, Demat charges and administrative expenses. The AO had not examined the accounts or given a finding how the assessee's computation was wrong.

DCIT Vs. Ashish Jhunjhunwala May 22 2013 (ITAT Kolkata)

In AY 2009-10, the assessee earned tax-free dividend of Rs. 32 lakhs on investments that had been made in earlier years. The assessee claimed that as he had not incurred any expenditure to earn the dividend income, no disallowance u/s 14A was permissible. The AO rejected the claim and made a disallowance by applying Rule 8D. The CIT (A) deleted the disallowance on the ground that the AO had mechanically applied Rule 8D to compute the disallowance. On Appeal the Tribunal held that the AO has not brought on record anything which proves that there is any expenditure incurred towards earning of dividend income. The AO has not examined the accounts of the assessee and there is no satisfaction recorded by the AO about the correctness of the claim of the assessee and without the same he invoked Rule 8D. While rejecting the claim of the assessee with regard to expenditure or no expenditure, as the case may be, in relation to exempted income, the AO has to indicate cogent reasons for the same. The AO has not considered the claim of the assessee and straight away embarked upon computing disallowance under Rule 8D of the Rules on presuming the average value of investment at ½% of the total value. This is not permissible

Dy. CIT v. Philips Carbon Black Ltd. (2011) 133 ITD 189 (Kol.)(TM)(Trib.)

The assessee claimed that no expenditure was incurred for earning for earning tax free income. Assessing Officer held that some expenditure must have been incurred to earn said income and he estimated 1 percent of tax free income and disallowed Rs. 42,130 under section 14A. Commissioner (Appeals) by applying Rule 8D retrospectively, disallowed Rs. 10.29 lakhs. Assessee before Tribunal challenged applicability of Rule 8D. The Tribunal held that Rule 8D was not applicable, however, went into reasonableness of estimation and

Quantification before Tribunal, estimation as made by Assessing Officer was to be up held.

Eih associated hotels ltd. Vs. DCIT (2009) 126 TTJ (Kol) 246

Neither the assessee nor the Revenue having challenged the estimation of the amount disallowable as made by the AO, it is not open to the Tribunal to go into the question of quantification of the amount disallowable. Therefore, the amount disallowable under S. 14A is sustained only to the extent of 1 per cent of the total exempt income.

Sagrika Goods & Services Pvt. Ltd. Vs. Income-tax Officer, I.T.A No. 1278/Kol/2010

It was held that on the issue of disallowance u/s. 14A, this Bench of the Tribunal has been taking a consistent view that this disallowance should be restricted to 1% of dividend income. Similar principle was upheld in **DCIT Vs. The Ashoka Trading Co. Pvt. Ltd. ITA Nos. 2270 & 2271 (Kol) of 2010** ,**The Diamond Co Ltd Vs. DCIT ITA No.1625/Kol/2010, S.R. Batliboi & Co., Kolkata Vs. Assessee I.T.A No. 1598/Kol/2011**, and in **Industrial Associates, Kolkata Vs. Department Of Income Tax I.T.A No. 2130/Kol/2010.**

XV. CONCLUSION

Object of section 14A is to disallow expenditure incurred in relation to income which does not form part of total income. When exempt income itself does not form part of 'business profits' of assessee, there can be no scope for allowing deduction of expenses incurred in relation to such income.

Law casts a duty on assessee to disclose fully and truly all material facts necessary for assessment. Even where assessee claims that no expenditure has been incurred in relation to income, which does not form part of total income, AO is required to verify correctness of such claim before invoking rigours of Rule 8D.

it is only when AO is not satisfied with correctness of claim of the assessee in respect of an expenditure or no expenditure having been incurred in relation to exempt income, that the mandate of Rule 8D will operate

In a situation in which assessee does not offer any disallowance u/s 14A in respect of a tax exempt income, provisions of Section 14A(2) r/w rule 8 D can be invoked u/s 14A(3). Interest expenses directly attributable to tax exempt income as also directly attributable to taxable income, are required to be excluded from computation of common interest expenses to be allocated under Rule 8D(2)(ii).

XVI. ANNEXURE I

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 subrule (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:-

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

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.

XVII. ANNEXURE II

Illustration

The assessee is in the business of trading of spare parts. The assessee had made investments from internal accruals, in earlier years, of Rs.---- lakhs in equity shares in XYZ Ltd. the assessee has not incurred any interest on borrowings for investments.

The assessee company derived “other income”. It is seen that during the Previous years the assessee company had received dividend income and claimed exemption under Section 10(34) of the Income tax Act.

During the current year, the assessee has not earned any dividend income. The profit and loss account of the assessee shows that it has not incurred any direct expenditure in relation to the above income.

The AO has made disallowance under Section 14A by applying Rule 8D.

S NO	TYPE OF EXPINDITURE	OPENING BALANCE	CLOSING BALANCE	TOTAL/AVERAGE
1.	Direct Expenditure	0	0	0
2.	Expenditure by way of interest			1,00,000

	(A)			
3.	Average value of investments (B)	50.000	52,000	51,000 (AVERAGE)
4.	Average of total assets (C)	48.000	50,000	49,000 (AVERAGE)
5.	An amount equal to one half of average value of investments	50,000	48.000	49,000/2 = 24500

Total expenditure = A* B/C= 1,00,000 X 51,000/49,000 = 104081 +24500 = 128581.6

Disallowance = 128581.6

Considering the above the assessee may contend

In case of item 2 the AO has considered the interest paid on fixed loans and interest on others totalling Rs. 1,00,000 as interest not directly attributable to any particular income and has disallowed the same. The AO has not considered the details and letters from banks filed by him stating that there were no borrowings for investments in shares. Since there were no borrowings for investments in shares no interest can be attributed for earring of exempted income.

The AO has not noted that item 2 will apply only in case where the assessee has incurred expenditure by way of interest during the previous year which is not attributable to any particular income or

receipt, an amount computed in accordance with the formula. The AO should have note that expenditure by way of interest has been incurred only for the business of trading and the interest is therefore directly attributable to trading income.

In case of item 3 the AO has made disallowance of 24500. He failed to note that there has been no new investment during the year and there is only a reduction in investments. It is also submitted that no dividend income was received during the year.

The assessee may rely on **ETHIO PLASTICS PVT LTD VS DCIT 2013-TIOL-20-ITAT-AHM, CIT-II Vs. Hero Cycles Ltd.[(323 ITR 518)], ACIT vs SUN INVESTMENTS 8ITR (TRB)33**

The disallowance is uncalled for.

A similar issue has been dealt by the ITAT Kolkata in REI Agro Ltd vs. DCIT , june 24th 2013

Where the facts of the case was, In AY 2008-09, the assessee invested Rs.103 crores in shares on which it earned tax-free dividends of Rs. 1.3 lakhs. The assessee claimed that though its borrowings had increased by Rs. 122 crores, the said investments were funded out of own funds like capital and profits. It claimed that no expenditure had been incurred to earn the dividends and no disallowance u/s 14A could be made. The AO applied Rule 8D and computed the disallowance at Rs. 4 crore. On appeal by the assessee, the CIT(A) reduced the disallowance to Rs. 26 lakh. On appeal, the Tribunal held

(i) Rule 8D(2)(ii) is a computation provision in respect of expenditure incurred by way of interest which is not directly attributable to any particular income or receipt. This clearly means that interest

expenditure which is directly relatable to any particular income or receipt is not to be considered under rule 8D(2)(ii). The AO has to show that the interest is not directly attributable to any particular income or receipt. In the assessee's case, the interest has been paid on loans taken from banks for business purpose. There is no allegation that the loan funds have been diverted for making investment in shares or for non-business purposes. The loans are for specific business purposes and no bank would permit the loan given for one purpose to be used for making any investment in shares. Also, the assessee has substantial capital & reserves. Accordingly, the interest on the loans cannot be included in Rule 8D(2)(ii);

(ii) Further, in Rule 8D(2)(ii), the words used in numerator B are "*the average value of the investment, income from which does not form or shall not form part of the total income as appearing in the balance-sheet as on the first day and in the last day of the previous year*". The AO was wrong in taking taken into consideration the investment of Rs.103 crores made during the year which has not earned any dividend or exempt income. It is only the average of the value of the investment from which the income has been earned which is not falling within the part of the total income that is to be considered. Thus, it is not the total investment at the beginning of the year and at the end of the year, which is to be considered but it is the average of the value of investments which has given rise to the income which does not form part of the total income which is to be considered. The term "*average of the value of investment*" is used to take care of cases where there is the issue of dividend striping;

(iii) Under Rule 8D(2)(iii), what is disallowable is an amount equal to ½ percentage of the average value of investment the income from which does not or shall not form part of the total income. Thus, under sub-

clause (iii), what is disallowed is ½ percentage of the numerator B in rule 8D(2)(ii). This has to be calculated on the same lines as mentioned earlier in respect of Numerator B in rule 8D(2)(ii). Thus, not all investments become the subject-matter of consideration when computing disallowance u/s 14A read with rule 8D. The disallowance u/s 14A read with rule 8D is to be in relation to the income which does not form part of the total income and this can be done only by taking into consideration the investment which has given rise to this income which does not form part of the total income.

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