

# Dilution of Section 14A

A ready reckoner

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## INTRODUCTION

Section 14A has been introduced by the Finance Act 2001 with retrospective effect from 1962. The provision was originally introduced to restrict the allowance of expenditure on income which does not form part of the total income. In other words, the provision disallows any expenditure incurred towards the earning of exempt income. Even after the introduction, the taxpayers preferred not to expressly provide for expenditure incurred towards such exempt income or show the minimal as it might get disallowed in the hands of the assessee.

Subsequently to facilitate the provision, Rule 8D was introduced in Income Tax Rules, 2008 with effect from 24.3.2008. As per the rules, the disallowance is the aggregate of the following items incurred towards income which does not form part of the total income.

- a. Amount of interest expenditure incurred
- b. Expenditure incurred by way of interest \* Average of value of investment/Average of total assets
- c. 0.5% of the average of the value of investment,

The Introduction of Rule 8D has had big blow on the taxpayers earning huge dividend income, or investments, assets, borrowed funds or interest expenditure.

To overcome the above rule, the tax payers had to resort to numerous legal and logical defenses. Different jurisdictional courts have taken different views on each of the defenses taken by the tax-payers which according to the author diluted the provision itself. This is in addition to the introduction of Dividend Distribution Tax in

the hands of the recipient above 10 lakhs. In other words, income beyond 10 lakhs forms part of the total income of the assessee and hence section 14A will not be applicable in such case.

Now, let us look at the different grounds taken by the taxpayers to restrict, if not nullify the provision of section 14A r.w.r 8D.

#### **I. Rule 8D not applicable till AY 2008-09**

Rule 8D came into force with effect from 24.3.2008 and hence prospective in nature. The courts resorted to make an *ad hoc* disallowance for the period prior to application of Rule 8D.

Originally the Rule 8D was held to be ineffective till AY 2007-08 by Bombay Tribunal in the case of Godrej & Boyce mfg. & Co. Ltd vs. DCIT - 328 ITR 81 Mumbai High Court.

Subsequently the provision has been interpreted to be inapplicable for AY 2008-09 as well by the decision of the Chennai Tribunal in the case of TVS Investments Limited Vs ACIT (ITA No. 1609/Mds/2012) which was followed a number of cases.

The disallowance is computed on the income which does not form part of the total income. Let's take the following example for the purpose of computation u/s 14A:

*Example 1 - X Company invested an amount of Rs. 5 crores. From the investment, income earned which does not form part of the total income amounts to Rs. 75 lakhs.*

Here, the disallowance u/s 14A is mostly calculated at 2% on Rs. 75 lakhs amounting to Rs. 1,50,000/-.

#### **II. Investment not yielding exempt income to be excluded**

Section 14A of the Act provides for exclusion of expenditure incurred towards earning of exempt income. Though Rule 8D deals with total investments, the investments which do not yield exempt income must be deleted for the purpose of section 14A.

Sub-section (2) of Section 14A reads as follows:

*“(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”*

Also sub-section (2) of Rule 8D is extracted below:

*“(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely :—“*

Hence, the disallowance u/s. 14A r/w rule 8D could be done only on investments which had given rise to income which does not form part of total income. The following decisions affirm the legal proposition:

- a. Rei Agro Ltd Vs DCIT (144 ITD 0141)
- b. Computer Age Management Services (P) Ltd Vs ACIT ITA No. 1259 to 1261/Mds/2014

**Rule 8D Computation Table - Illustration**

i)		Expenditure Incurred in connection with Earning of Dividend	NIL
ii)	A	Interest Expenditure Incurred	11,015,238
	B	Average value Of Investment on exempt Income (Average of Closing and Opening of Investments)	7,808,176
	C	Average of Closing and Opening Assets of Balance Sheet	1,041,303,073
		<b>A X B/C</b>	82,597
iii)		1/2% (Average of Closing and Opening of Investments)	39,041
		Total Value as per Rule 8D (i + ii + iii)	1,21,638

	(0 + 82597 + 39041)	
	<p>Investments are made in different parts such as:</p> <ol style="list-style-type: none"> <li>1. Investment in mutual funds - Rs.19,521/-</li> <li>2. Investment in equities - Rs. 18,621/-</li> <li>3. Investment in bonds Rs. 19, 520/-</li> <li>4. Investment in Group Companies - Rs 20,420/-</li> </ol>	

### **Example 2**

In the above illustration, the investment in equities does not fetch any income which is exempt under the Act. Hence, for the purpose of determining the value of investment under 2<sup>nd</sup> and 3<sup>rd</sup> limb of Rule 8D, the investment is restricted to investment in Mutual funds and Bonds. The amount of Rs. 18,621/- is excluded for the determining the disallowance under the provision.

### **III. Disallowance cannot exceed exempt income**

It is to be noted that disallowance u/s 14A is more of notional expenditure. The notional expenditure is calculated to determine the expenditure that could have been incurred for the purpose of earning income which does not form part of the total income. And the business prudence demands that expenditure towards earning an income cannot exceed the income itself. The following decisions uphold the said position of law:

- a. Joint Investments Pvt Ltd Vs CIT ITA 117/2015
- b. DCM Ltd Vs DCIT I.T.A .No. 4467/Del/2012

Also, the Finance Minister Arun Jatley in his finance speech has specifically states that disallowance under section 14A cannot exceed exempt income. The required amendment to rule 8D is yet to be made.

### **Example 3**

In the same table of computation u/r 8D, the disallowance is calculated at Rs. 1,21,041/-. However if the assessee has earned dividend income only of Rs. 75,000/- from all the investments made, the disallowance under the provision cannot exceed Rs. 75,000/- though the notional expenditure under the provision is higher. Hence, the disallowance under the provision is restricted to Rs. 75,000/-.

#### **IV. No disallowance if no exempt income**

The above proposition can be stretched to say that disallowance cannot be made if there exists no exempt income. Section 14A specifically deals with expenditure incurred towards earning exempt income. Where the assessee has not earned any income which does not form part of the total income, the provision will not be applicable and the disallowance under the provision is not warranted. This view has been taken in the following cases:

- a. ACIT Vs M. Baskaran 152 ITD 0844 (Chennai)
- b. Cheminvest Ltd Vs CIT ITA 749/2014 Del HC
- c. CIT Vs Shivam Motors (P) Ltd 89 CCH 0059 All HC

Also, it should be understood that the disallowance of expenditure is towards exempt income and not investments. Crores of investment yielding no exempt income attracts no disallowance as the criteria for computing the disallowance is the exempt income and not the investments.

**Example 4** -In the same example above, if the no income has been earned by the assessee which is exempt under any of the provisions of the Act, section 14A itself cannot be applied. Hence, the application of 8D does not arise and no disallowance is made under the provision. It is pertinent to note that even the *ad hoc* disallowance is not made as the provision of section 14A on income which does not form part of the total income.

## V. Investments in Subsidiaries

Investment made in a subsidiary is none other than investment made for its own business. This issue has been settled by the Hon'ble Supreme Court in the case of S.A Builders (288 ITR 1) and Hero Cycles Vs CIT (CA No. 514 of 2008). Hence, any investment made in subsidiaries out of borrowed funds is deemed to be used for the purpose of business and no disallowance under the provision could be made on such interest expenditure. This proposition of law has been laid down in the following case:

- a. EIH Associated Hotels Limited Vs DCIT I.T.A. No. 1503/Mds/2012
- b. JM FINANCIAL LTD Vs ACIT 2014-TIOL-202-ITAT-MUM

**Example 5** - In the same example mentioned above, the investment in subsidiaries should also be excluded amounting to Rs. Rs 20,420/-. Hence, the value of investment will be reduced proportionally in second and third limb of Rule 8D. The computation works as under:

i)		Expenditure Incurred in connection with Earning of Dividend	NIL
ii)	A	Interest Expenditure Incurred	1,10,15,238
	B	Average value Of Investment on exempt Income (Average of Closing and Opening of Investments)	39,041
	C	Average of Closing and Opening Assets of Balance Sheet	1,04,13,03,073
		<b>A X B/C</b>	413
iii)		1/2% (Average of Closing and Opening of Investments)	19,521
		Total Value as per Rule 8D (i + ii + iii) (0 + 413 + 19,521)	19,934

	Investments are made in different parts such as:	
	<ol style="list-style-type: none"> <li>1. Investment in mutual funds - Rs.19,521/-</li> <li>2. Investment in equities - Rs. 18,621/- (Excluded)</li> <li>3. Investment in bonds Rs. 19, 520/-</li> <li>4. Investment in Group Companies - Rs 20,420/- (Excluded)</li> </ol>	

#### **VI. 14A disallowance not applicable under Book Profits**

Under section 115JB of the Income Tax Act, book profits are computed without considering the adjustments which are otherwise allowable under the normal provision of the Act. Any adjustments to the 'book profits' should be in accordance with section 115J of the Act. In other words, while computing the "Book Profit" of the company under the provision of section 115JB, any disallowance made under the normal provision of the Act cannot be given effect for arriving at the "Book Profit" for the purpose of section 115JB of the Act. This view has been concurred by the following decisions:

- a. M/s Apollo Tyres Ltd. Vs CIT (255 ITR 273)
- b. M/s Beach Minerals Co Lt. Vs ACIT (ITA No. 2110/Mds/2014)
- c. Shriram Capital Ltd. Vs CIT (I.T.A. Nos.512 &513 /Mds/2015)

Hence, the disallowance made u/s.14A r.w.r 8D cannot be added while computing book profit u/s.115JB of the Act since the disallowance is only disallowance for the purpose of computing taxable income of the assessee in the normal course(income tax). There is no provision in the Act to add such notional expenditure while computing book profit u/s.115JB and hence cannot change the book profit on this count.

## VII. Specific business Loans

The interest expenditure incurred towards specific business loans has to be excluded for the purpose of disallowance under Rule 8D(2)(i). It is a refutable presumption that borrowed funds are utilized for the purpose of making investments. However, where the borrowed funds are for specific business purpose, the same should be excluded in determining the disallowance under section 14A r.w.r 8D.

In the above illustration, the interest expenditure incurred is Rs. 1,10,15,238/-. The assessee has a borrowings of Rs. 11,01,52,380 @ 10% interest amounting to Rs. 1,10,15,238/-. Out of Rs. 5,00,00,000/- were loans for specific business purpose such as purchase of plant & machinery, purchase of land etc. These expenditure being business specific loans, the same should be excluded and the only balance amounting to Rs. 6,01,52,380/- is taken for the purpose of rule 8D. The revised interest expenditure amounts to Rs. 60,15,238/-

The computation is as follows:

i)		Expenditure Incurred in connection with Earning of Dividend	NIL
ii)	A	Interest Expenditure Incurred	60,15,238/-
	B	Average value Of Investment on exempt Income (Average of Closing and Opening of Investments)	39,041
	C	Average of Closing and Opening Assets of Balance Sheet	1,04,13,03,073
		<b>A X B/C</b>	226
iii)		1/2% (Average of Closing and Opening of Investments)	19,521
		Total Value as per Rule 8D (i + ii + iii) (0 + 226 + 19,521)	19,747



### VIII. Business of investment

Where the assessee is in the business of investments, then dividend earned from such business activity becomes business income of the assessee which is accessible to tax under the Income Tax Act. In other words, where the shares are held as stock-in-trade, the question of disallowance u/s 14A does not arise as the same would obviously form part of the total income. The logic has been accepted by the following judicial pronouncements:

- a. MSA Security Services Vs ACIT (ITA No. 1524/Mds/2012)
- b. DCIT Vs G. K. K. Capital Markets (P) Ltd I.T.A No.805/Kol/2012

Hence, no disallowance u/s 14A is applicable if the same is held as stock-in-trade by the assessee.

### IX. Foreign dividend

Foreign dividend is taxable in India. That is, the income forms part of the total income and hence, the disallowance under section 14A is not applicable to foreign dividend.

*“Tax on dividends, royalty and technical service fees in the case of foreign companies.*

**115A.** (1) *Where the total income of—*

(a) *a non-resident (not being a company) or of a foreign company, includes any income by way of—*

- (i) *dividends other than dividends referred to in [section 115-O](#); or*
- (ii) *.....*
- (iii) *.....*

*the income-tax payable shall be aggregate of—*

*(A) the amount of income-tax calculated on the amount of income by way of dividends other than dividends referred to in [section 115-O](#), if any, included in the total income, at the rate of twenty per cent ;”*

Sometimes, dividend income is considered in entirety without bi-furcating the dividend income earned within and outside India. Only the expenditure incurred towards earning of the domestic dividend income which does not forms part of the total income alone can be disallowed u/s 14A. Since, the income has been included in the total income and tax is accordingly paid, the disallowance under the provision is not warranted.

#### **X. Presence of Reserves and Surplus**

For computing the disallowance under rule 8D, the presence of “Reserves and Surplus” plays a crucial role. Usually it is expected to be more than the investments made. If the assessee has sufficient Reserves and Surplus, it is presumed that such investments have been made out of own funds. Otherwise, it is assumed that investments were made out of borrowed funds for which interest expenditure is incurred by the assessee whereby such interest expenditure is directly relatable to earning of such exempt income. However, where the assessee could prove that it has sufficient reserves and surplus, the disallowance cannot be called for. This ratio has been propounded by the following decision:

- a. CIT Vs Hotel Savera 239 ITR 795 (Mad HC)
- b. CIT Vs HDFC Bank Ltd 89 CCH 0185 (Bom HC)
- c. CIT Vs Gujarat State Fertilizers & Chemicals Ltd 85 CCH 273 (Guj HC)
- d. CIT Vs SBI DHFL Ltd (1524/Mds/2012) (Bom HC)

Hence, in the computation under rule 8D, the interest expenditure under the second limb is reduced on the logical and legal presumption that all the investments are made of Reserves and Surplus and no interest expenditure has been incurred by

assessee for earning such exempt income for the purpose of Section 14A read with rule 8D.

## **XI. Satisfaction of AO**

Sub-rule (1) of Rule 8D of the Income Tax Rules states that Assessing Officer shall determine expenditure under sub-rule (2) if he is not satisfied with the correctness of claim of expenditure or where no such expenditure has been incurred.

The relevant provision under rule 8D reads as follows:

*“8D. (1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with—*

- (a) the correctness of the claim of expenditure made by the assessee; or*
- (b) the claim made by the assessee that no expenditure has been incurred in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).”*

In other words, only when the Assessing Authority is not satisfied under sub-rule (1), the notional expenditure under sub-rule (2) could be made. And hence, the Assessing Authority is required to record his satisfaction for determination of the notional expenditure under sub-rule (2) of Rule 8D. The above interpretation gains substantiation from the following decisions:

- a. Shriram Properties Pvt. Ltd Vs ACIT 36 CCH 297 ChenTrib
- b. CIT Vs Hero Management Service Limited 360 ITR 68 (Delhi)

## **XII. Only actual expenditure to be disallowed u/s 14A**

Disallowance u/s 14A is on the expenditure incurred for earning income which does not form part of the total income. The expression ‘expenditure incurred’ refers to the

actual expenditure incurred for earning the exempt income and not the notional expenditure that ought to have been expended for the purpose of earning the exempt income. This theory was enunciated by the following decisions:

- a. CIT Vs Hero Cycles Ltd 323 ITR 518
- b. CIT Vs Deepak Mittal (361 ITR 131)
- c. IT Vs Deepak Mittal 86 CCH 051 PHHC

Also, Finance Minister Mr. Arun Jatley in the Budget Speech 2016 has stated that disallowance under 14A to be on actual expenditure.

In the above illustration of computation under rule 8D, the notional amount which would have been expended by the assessee for earning the income was computed. This is the legal presumption under rule 8D. However, assessee can establish and prove the actual expenditure incurred. On sufficient proof and reasoning, the courts have come to conclusion that no notional expenditure can be disallowed.

### **XIII. Historical Investments**

Long term investments made in the past are referred to as historical investments. These investments are *per se* not a defense to avoid disallowance as the same might yield exempt income and no disallowance can be made if no exempt income is earned during the relevant financial year. However, it can be substantiated that no actual expenditure has been incurred by the assessee for earning the exempt income wherein the assessee would be required to substantiate that no investments were made during the relevant year, no investment related decisions were made, expenditure has not been incurred for receiving the exempt income etc. This proposition flows from the concept of non-disallowance of notional expenditure.

### **XIV. No disallowance if dividend income exceeds 10 Lakhs**

Recently, by the Finance Act, 2016 dividend distribution by the companies are taxable in the hands of the recipient also at the rate of 10%. Such being the case, the dividend income earned by the recipient forms part of the total income and will not be exigible to tax under section 14A r.w.r 8D.

The Finance Bill 2016 reads as under:

*“Clause 50 of the Bill seeks to insert a new section 115BBDA in the Income-tax Act relating to tax on certain dividends received from domestic companies.*

*The provisions of the Income-tax Act provide that dividend income shall be exempt if dividend distribution tax is paid on such income.*

*It is proposed to insert a new section 115BBDA in the said Act so as to provide that **any income by way of dividend declared, distributed or paid by a domestic company, in excess of ten lakh rupees shall be chargeable to tax at the rate of ten per cent. in the case of an individual, Hindu undivided family or a firm who is a resident in India.***

*It is further proposed to provide that no deduction in respect of any expenditure or allowance or set off of loss shall be allowed in computing the income by way of dividend and to define the term dividends.*

*This amendment will take effect from 1st April, 2017 and will, accordingly, apply in relation to assessment year 2017-2018 and subsequent years.”*

Thus, dividend income above 10 lakhs would be exigible to tax at the rate of 10% and therefore, forms part of total. Hence, dividend income above 10 lakhs is not subject to disallowance u/s 14A of the Income Tax Act.