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Recent Important Judgements On Disallowance u/s 14A & Rule 8D

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Disallowance u/s 14A of the Income Tax Act 1961 has always been the subject matter of dispute before the tax authorities, Appellate Tribunal and the courts. Recently, certain decisions have been delivered by the courts which have great impact on the scope of disallowance u/s 14A of the Act.

One of the disputes before the tax authorities had been as to whether disallowance u/s 14A could be made in the absence of exempted income not forming part of the Total income u/s 10 of the Act. The special bench of the Tribunal, in the case of Cheminvest Ltd.-v-ITO 121 ITD 318, had held that expenditure incurred in acquiring the shares either by way of investment or stock in trade could be disallowed even if no dividend was received on such shares. This legal position is no more good law in view of certain decisions of high courts discussed hereafter:

CIT-vs-Delite Enterprises –judgment dated 26.2.2009 of Bom HC

This is the first decision of a high court where the question arose whether the provisions of section 14A could be invoked where the assessee had not earned any income not forming part of total income. In this case, the assessee was partner of a firm wherein it invested capital out of borrowed funds on which it was entitled to interest which was taxable under the Act. However no share of profit, exempt u/s 10(2A), was received from the firm. The AO disallowed interest paid by assessee by invoking the provisions of section 14A in respect of asst. years 2001-02 & 2002-03 since income from the firm was exempt u/s 10(2A). It is to be noted that in first year, there was loss and therefore the assessee had not even received the interest in terms of partnership deed.

On appeal, the CIT(A) held that the interest was allowable u/s 36(1)(iii) as the expenditure was incurred for the purpose of earning taxable income and non receipt of income could not be a ground for disallowing such expenditure in AY 2001-02. For the similar reason, he deleted the disallowance in AY 2002-03. Aggrieved by the same, the revenue preferred appeals before the hon'ble tribunal. **The hon'ble tribunal opined that in the absence of exempted income u/s 10(2A), the provisions of section 14A could not be invoked.** On appeal by the revenue, the hon'ble Bom high court refused to answer the question since there was no profit received by the assessee from the firm. The order of the tribunal stood confirmed impliedly.

It is to be noted that one can argue that such decision does not lay down any preposition of law since the court refused to answer the question. However such view expressed by the tribunal stands fortified by other decisions.

CIT v.Winsome Textile Industries Ltd. [2009] 319 ITR 204 (PH)

This is the first decision of a high court where it has been expressly observed that the provisions of section 14A cannot be invoked where the assessee had not earned any income not forming part of total income. In this case, the assessee was engaged in manufacture and sale of cotton yarn. During assessment proceedings, the Assessing Officer disallowed interest on the amount of investment in shares on the ground that since dividend income is exempt from tax u/s 10, the provisions of section 14A were applicable. Before the CIT(A), it was **contended** by the assessee that it had not claimed any income to be exempt from taxation and therefore, the provisions of section 14A cannot be invoked by the AO. However, the CIT(A) found that investment in shares was made in earlier years out of its own funds and therefore deleted the disallowance u/s 14A. The tribunal affirmed the order of the CIT(A) since there was no nexus between borrowed funds and the investment made in shares. On further appeal by the revenue, the hon'ble high court also affirmed the finding of the Tribunal considering the facts. But it is interesting to note the legal observations made by the high court in the last para of its decision **“In the present case, admittedly, the assessee did not make any claim for exemption. In such a situation, section 14A could have no application.”** Though these observations were obiter dicta yet are important as it gave food for thought for the appellate authorities as well as other high courts. These observations were quite opposite to the decision of the special bench of the hon'ble Tribunal in the case of Cheminvest Ltd (Supra).

It is important to note that various benches of the hon'ble Tribunal has followed the above obiter dicta and allowed the appeals. Even this view has been accepted by other high courts which are discussed below.

CIT-vs- Corrttech Energy (P.) Ltd. [2014] 45 taxmann.com 116 (Gujarat)

In this case, the assessee had acquired shares by way of investment out of its own as well as borrowed funds. The assessee claimed interest as deduction but the AO disallowed proportionately by invoking the provisions of section 14A read with Rule 8D. On appeal, it was the stand of the assessee before the Commissioner (Appeals) that no such disallowance could be made since it had not earned any dividend on such investments. However, the CIT(A) confirmed such disallowance by observing that the assessee made investment in shares which would result only in dividends which would be exempt from tax and that not receiving any exempt income during current year would not entitle assessee to claim expenses related to investments. On second appeal, the **Tribunal** held that where the assessee had not claimed any exempted income u/s 10 in this year, the provisions of section 14A could have no application. **In coming to this conclusion, the Tribunal relied on the decision of the hon'ble Punjab and Haryana High Court in case of CIT v. Winsome Textile Industries Ltd. [2009] 319 ITR 204** wherein the Court had observed that where the assessee did not make any claim for exemption, section 14A could have no application.

On further appeal by the revenue, **the hon'ble high court** observed as under:-

“4.----- We however, notice that sub-section(1) of section 14A provides that for the purpose of computing total income under chapter IV of the Act, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. In the present case, the tribunal has recorded the finding of fact that the assessee did not make any claim for exemption of any income from payment of tax. It was on this basis that the tribunal held that disallowance under section

14A of the Act could not be made. In the process tribunal relied on the decision of Division Bench of Punjab and Haryana High Court in case of *CIT v Winsome Textile Industries Ltd.* 319 ITR 204 in which also the Court had observed as under :

" . We do not find any merit in this submission. The judgement of this court in *Abhishek Industries Ltd (2006) 286 ITR 1* was on the issue of allowability of interest paid on loans given to sister concerns, without interest. It was held that deduction for interest was permissible when loan was taken for business purpose and not for diverting the same to sister concern without having nexus with the business. The observations made therein have to be read in that context. **In the present case, admittedly the assessee did not make any claim for exemption. In such a situation section 14A could have no application.**"

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

Thus, the hon'ble Guj HC has endorsed the view taken by the hon'ble Pb. & Hr. HC to the effect that section 14A cannot be invoked where the assessee has not earned income not forming part of total income.

CIT-vs-Shivam Motors--judgment dated 5.5.2014 of ALL high court

In this case also, the assessee had acquired shares of a finance company against which no dividend was received. However, the AO disallowed the expenditure by way of interest by invoking the provisions of section 14A. The issue before the tribunal was whether such disallowance could be made by the AO. One of the contentions raised by the assessee was that no disallowance u/s 14A could be made in the absence of income not forming part of the total income. This contention found favour with the tribunal and therefore upheld the order of CIT(A) deleting the disallowance by observing as under:-

6. "Having heard the rival submissions and from a careful perusal of the record in the light of the relevant provisions of the Act, we find that as per the provisions of Section 14A, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income, which does not form part of the total income under this Act. **Meaning thereby the basic condition precedent for invoking the provisions of section 14A is that there should be income, which does not form part of the total income under this Act.** Thus, wherever the assessee earned the interest free income, the corresponding expenditure incurred in earning that income is to be disallowed. **In the absence of any interest free income, there cannot be any disallowance as no corresponding expenditures were incurred to earn a particular tax free income.**"

On further appeal, the hon'ble Allahabad high court has affirmed the order of the tribunal by observing as under:

"As regards the second question, Section 14A of the Act provides that for the purposes of computing the total income under the Chapter, no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under the Act. Hence, what Section 14A provides is that if there is any income which does not form part of the income under the Act, the expenditure which is

incurred for earning the income is not an allowable deduction. **For the year in question, the finding of fact is that the assessee had not earned any tax free income. Hence, in the absence of any tax free income, the corresponding expenditure could not be worked out for disallowance.”**

CIT-vs-Lakhani Marketing Incl---Judgment dated 02.04.14 of Pb & Hr HC

In this case, the assessee acquired shares out of borrowed funds but no dividend was received on such shares. However, the AO disallowed the expenditure by way of interest by invoking the provisions of section 14A but the CIT(A) allowed the appeal and deleted the disallowance. On appeal by the revenue, the tribunal opined that following conditions must be satisfied before invoking the provisions of section 14A of the Act:-

- That there must be income taxable under the Act;
- That this income must not form part of the total income;
- That there must be 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.

The tribunal found that the assessee had not earned any income by way of dividend income not forming part of the total income under the Act. Hence, the order of CIT(A) was confirmed.

On further appeal by the revenue, the hon’ble high court has affirmed the order of the tribunal following its earlier decision in case of Winsome Textile Industries (supra).

It is clear from all the above decisions that uniform view has been expressed by the hon’ble high courts of Pb. & Hr., Bombay, Gujarat and Allahabad to the effect that the provisions of section 14A cannot be invoked by the tax authorities where the assessee has not earned the income not forming part of the total income. Logically, it follows that earning of exempted u/s 10 is the condition precedent for disallowance u/s 14A of the Act. There is no contrary view of any high court on this issue. Hence, in my view, it is binding on the tribunal as well as the appellate authority.

However, there may be cases where the assessee has invested borrowed funds in various companies but dividend has been received only from few companies. The question arises whether the revenue authorities can disallow the entire interest by applying the provisions of section 14A? In my humble view, each investment must be examined independently since section 14A applies to the expenditure in relation to income not forming part of the total income. Therefore, no disallowance can be made u/s 14A in respect of expenditure where no income has been earned in relation to the investment though out of borrowed funds. **For example**, a dealer in shares invests the borrowed funds in shares of 50 companies out of which no dividends were received from 45 companies since sold in the year before declaration of dividends. In such cases, no disallowance can be made of expenditure by way of interest qua 45 companies since no income not forming part of the total income was earned.

However, it is to be noted that the hon'ble Karnatka HC, in the case of CCI Ltd. 206 Taxman 563, has held that no disallowance u/s 14A, whatsoever, can be made in case of dealers in shares & securities even though the assessee had earned the income exempt from tax u/s 10 of the Act. This view has also been followed by various benches of the tribunal.

On the same line of reasoning, no disallowance can be made u/s 14A where investment has been made in shares of other companies out of commercial expediency but no dividend is received.

Hope, this discussion would help the readers. In case of any doubt, the readers may mail at kaushalsinghal15@gmail.com

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