A Fresh look at disallowances u/s 14A of Income Tax Act
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Now a days, every assessee who is doing investment or trading in shares are getting hit hard by the impact of section 14A. Of late, a number of High Court and Tribunal judgements have been passed, and some of the judgements have conflicting views. In this article an attempt has been made to review the present status of section 14A of I.T. Act, keeping in mind various judicial pronouncements.

Legislative history and purpose of Sec. 14A
Section 14A has been inserted in Chapter IV of the Income-tax Act by the Finance Act 2001, with retrospective effect from April 1, 1962. This Section provided for disallowance of expenditure incurred in relation to income which is not included in the total income of the assessee. The retrospective amendment follows the position in law as laid down by the Supreme Court in CIT vs. Indian Bank Ltd. (56 ITR 77), CIT vs. Maharashtra Sugar Mills Ltd. (82 ITR 452) and Rajasthan State Warehousing Corporation vs. CIT ( 242 ITR 450). In all these judgements it was held that where an assessee carries indivisible business, income wherefrom is partly taxable and partly non- taxable, then no part of expenses shall be disallowed on the ground that the same is relatable to exempt income. The section 14A was brought in the statutory book to prevent misuse of these rulings by certain assesses to reduce the tax payable on taxable income by adjusting the expenditure incurred in relation to income which does not form part of the total income under the Act. In the Memorandum explaining the rationale of this provision, it was mentioned that the basic principle of taxation is to tax the net income, i.e. gross income minus the expenditure. On the same analogy, the exemption too, is in respect of the net income.

In this section, the first phrase is ‘for the purposes of computing the total income under this chapter’ which makes it clear that various heads of income, as prescribed under Chapter IV, would fall within Sec. 14A. The next phrase is ‘in relation to income which does not form part of total income under the Act’. It means that if certain income does not form part of the total income, then the related expenditure is outside the ambit of the applicability of Sec. 14A.

Now, let me discuss various judicial rulings on the issues involved.

1. Whether S. 14A disallowance can be made on shares held as stock in trade?

One of the major controversies surrounding, disallowance u/s 14A is whether expenditure can be disallowed under this section for those dealers who hold investments as stock in trade. With the passage of time different judgments of the court has come up in this matter which has made things more complicated.

This section provides for disallowance of expenditure in relation to the income which does not form part of total income under this Act. A dealer in shares and securities ordinarily receives income from transfer of shares. This income is chargeable to tax under the head ‘Profit & gains of Business/ Profession’. However, he may also receive dividend income on such shares which are exempted from tax in his hands. The question that arises here is whether it shall be presumed that some expenditure was
incurred for earning this exempted dividend income, which needs to be disallowed. Also it is necessary to determine whether Rule 8D can be applied for determining such expenditure.

In the case of CIT v/s Leena Ramchandran, the Kerala High Court (339 ITR 296) held that no disallowance of interest claimed u/s 36(1)(iii) should be made u/s 14A in the case of a dealer who purchased shares out of borrowed funds and held the same as stock-in-trade.

This issue also came up for consideration in the case of Maxopp Investment Ltd. Vs CIT before the Delhi High Court (347 ITR 272). In this case assessee was engaged in the business of dealing in securities. The Company borrowed funds to purchase these trading assets and claimed deduction u/s 36(1)(iii), being interest paid on loan. The Income in relation to trading in securities was chargeable as business income and dividend income was also received such shares. The Court held that no disallowance u/s 14A was attracted.

Similar view was held by Karnataka High Court in the case of CCI Ltd vs. JCIT (250 CTR 291).

A number of ITAT Judgments have been passed following the aforesaid judgments of the Hon’ble High Courts, wherein conflicting views have been taken.

For instance, in the case of DCIT v/s Gulshan Investment Co. Ltd (ITA No. 1012/Kol/2010), the assessee held shares as stock in trade and earned dividend income. It did not disallow any expenditure u/s 14A or Rule 8D contending that no disallowance can be done if shares are held as stock in trade but the CIT(A) disallowed the amount. The Tribunal held in this case that no disallowance can be done in this case as there is no investment. On the other hand, Mumbai ITAT in a number of judgments have held that no disallowance u/s 14A should be made where shares are held as Stock-in-Trade.

In the case of Yatish trading Co. Pvt. Ltd v/s ITAT (I.T.A. No. 7144/Mum/2008) the assessee was engaged in the business of trading in Shares and Securities and inter-alia earned tax free dividend income. The AO invoked s. 14A and disallowed the interest on borrowings, administrative and other expenses on proportionate basis. In appeal, the CIT (A) upheld the disallowance but directed that it should be computed as per Rule 8D. On appeal to the Tribunal, it was held that there must be a direct nexus between exempted income and expenditure in relation to such income. If the main purpose of business is trading in securities and dividend earning was incidental to this activity, it cannot be said that interest expenditure has been incurred for earning this dividend income.

Further the Mumbai ITAT in the case of Prakash k Shah & Securities P. Ltd vs. ACIT (ITAT No.3339/Mum/2010, Asst Year 2007-08) held that no disallowance can be made if shares are held as Stock-in-Trade.

Again, in the case of Ganjam Trading Co. Vs A.O. (ITA No.3724/Mum/2005) the Mumbai Tribunal followed the judgment of Karnataka High Court in the case of CCI Ltd. (supra) and held that no disallowance u/s 14A can be made for a dealer who holds shares as stock-in-trade and it applies in the case of Investment in Shares only.

Also, in the case of DCIT vs. India Advantage Securities Ltd. (ITA No. 6711/Mum/2011), the Tribunal followed the judgment of the High Court in the case of CCI Ltd. (supra) and held that no disallowance u/s 14A can be made for a dealer who holds share as Stock-in-trade.
The Mumbai ITAT recently gave a judgment on this issue in the case of *Vivek Mehrotra v. ACIT* (ITA No. 6332/Mum/2011). The Tribunal held that no Disallowance u/s 14A can be done for shares which are held as Stock-in-Trade.

However, Mumbai ITAT in the case of *JCIT vs. American Express Bank Ltd* (ITA No. 5904/Mum/2000) has held that disallowance u/s 14A is attracted where shares are held as stock-in-trade.

Very recently, *Kolkata ITAT in Gulshan Investment case passed on 11th March 2013 in Appeal No. ITA/666/Kol/2012* has given an interesting finding. It was held that the provisions of section 14A are indeed attracted whether or not shares are held as stock in trade or as investments, even though the provisions of rule 8D(2)(ii) and (iii) cannot be invoked in such a case, and even though the provisions of rule 8D(2)(i) are much narrower in scope than the scope of section 14A. *A simplicitor.*

In my view, the issue is more factual than legal and one has to look into very factual circumstances to come to a conclusion.

2. Whether S. 14A disallowance can be made even if there is no income on relevant investments?

It is a very difficult task to say whether expenditure is to be disallowed when no income is received from investments. Different judgements have come in this matter and in many cases they have given contradicting views.

In the case of *Cheminvest Ltd. Vs ITO* (121 ITD 318, Special Bench of ITAT Delhi), the assessee invested borrowed amount on the purchase of shares held, both as investment as well as stock-in-trade. The Assessing Officer disallowed assessee’s claim of proportionate interest pertaining to investment for earning of dividend, though exempt income was not earned during the relevant year. On appeal, the Commissioner (Appeals) upheld the order of the Assessing Officer. The Special Bench of ITAT held that disallowance can be made in a year in which no exempt income is received at all.

But in *Avshesh Mercantile Private Limited* (Mumbai ITAT - 13.06.2012) the tribunal held that no disallowance can be done if there is no exempt income and Investments are also capable of generating taxable income.

In a recent judgement passed by *Kolkata ITAT in the case of REI Agro Limited passed on 19.06.2013 in appeal no. 1331/Kol/2011*, it was held that disallowance u/s 14A is not attracted when no exempt income received from investments. In this case, it was observed that a perusal of the provision of section 14A(1) clearly shows the wordings, in relation to the income which doesn’t form part of the total income under this Act. If an assessee has invested in shares, which could get dividend or there is investment which generates exempt income as also investment which doesn’t generate exempt income, it is only such investments in respect of which the dividend income or exempted income has been earned which can be considered when computing the disallowance u/s 14A read with rule 8D.

3. Implication of expenditure incurred to earn the Share of profit from partnership firm?

Another question that arises is whether deduction can be claimed for expenditure incurred to earn the share of profit from the partnership firm. This issue has been addressed by the Special Bench of Ahmedabad ITAT in the case of *Vishnu Anant*.
In this case the assessee argued that his firm has already paid Income tax on his share of profit from the firm. Therefore he was entitled to get deduction for expenditure incurred by him for the aforesaid income. The Tribunal held that in the given case the assessee can't get deduction for expenditure incurred because income is not taxable in the hands of the assessee and Sec 14A does not allow deduction for expenditure which are exempted from tax in the hands of the assessee.

The above matter has also been addressed in the case of ACIT vs. Novel Enterprises (2012) 52 SOT 127 (Mum). In this case, the assessee firm received interest on capital from partnership firm as well as Share of profit. The Interest was taxable and share of profit was exempt. It was held that in the partnership deed, it was nowhere stated that share of profit was dependant on contribution of funds. Hence, Section 14A was held as not applicable.

4. Depreciation - whether subject to 14A disallowance?

Sec 14A calls for disallowance of expenditure incurred in relation to earning of an exempted income. It has been held in the case of Hoshang D. Nanavati (ITA No. 3567/Mum/07) that section 14A deals only with the expenditure and not any statutory allowance admissible to the assessee. In the case of Vishnu Anant Mahajan vs. ACIT (supra), the Special Bench of the Ahmedabad ITAT held that depreciation is a statutory allowance and so no amount u/s 14A is to be disallowed for depreciation allowance claimed u/s 32.

5. Effect of 14A disallowance on ‘book profit’ calculated as per MAT provisions u/s 115JB?

Sec 115JB provides for increase in book profit by the amount of expenditure relatable to any income exempt u/s 10(except 10(38)) and reducing book profit the amount of income relatable u/s 10(except 10(38)). Since mechanism is in place the rigmarole of determining the amount of expenditure to be added and year of applicability of the ‘prescribed method’ has to be undergone.

In the case of Goetze (India) Ltd v/s CIT, 32 SOT 101. The Tribunal held that Clause (f) of Sec. 115JB of the Act and Sec. 14A has the same meaning. Therefore provision of Sec. 14A can’t be applied with and no disallowance can be done by applying clause (b) and clause (c) of Sec. 14A. Also in the case of Gujarat State Energy Corporation Ltd v/s CIT, the Tribunal held that Sec. 115JB of the Act does not specifically cover Sec. 14A. So no additions can be made in Sec. 115JB by applying Sec 14A.

In my view Sec. 115JB is part of Chapter XII-B of the Income Tax Act while Section 14A is part of Chapter IV of the Act. Section 14A starts with the expression “for the purpose of computing Total Income under this Chapter...”. Chapter IV deals with the computation of Income under five heads as per normal provisions. Hence in my opinion, S.14A cannot apply on income calculated under different Chapter, i.e. Chapter XII-B for MAT provisions.

6. What if no expenses incurred?

It is also a controversial issue regarding whether disallowance u/s 14A can be done when there is no expenditure incurred to earn exempt income. Sub Section (2) and (3)
has been introduced prospectively w.e.f. 1.4.2007. Subsection (3) of the said section provisions of the said section shall apply in cases where no expenditure has been claimed by the assessee.

This issue has been addressed in the case of *Hero Cycles Ltd vs. CIT (323 ITR 158)*. In this case it was found that Investment were made out of sale proceeds of Shares, Bonus Shares, Dividend earned in the past and no expenditure was incurred to earn this exempted income. It was held that no disallowance can be done unless there is expenditure to earn this income.

7. Nexus of Income vs. Expenditure

In the case of *Reliance Utilities Ltd v/s CIT (ITA No 1398 of 2008)*, the Bombay High Court held that no disallowance can be done u/s 14A if Investment are done out of own funds and there is no administrative expenses in managing the fund.

Further in the case of *Walfort Share brokers v/s CIT*, the SC has held that unless proximate relation is established between income and expenditure there can be no disallowance u/s 14A.

This issue of disallowance u/s 14 A was also addressed in case of *Godrej and Boyce Mfg. Co. Ltd vs. CIT (328 ITR 81)*. In this case assessee has claimed a dividend of Rs. 34.34 crore as exempt income and it claimed that no expenditure was incurred to earn this income. The Assessee has borrowed some money and the A.O claimed that this was done for making investments in share and hence the interest was disallowed. The court held that it is important to establish a nexus between income and expenses and then only disallowance can be made by applying the prescribed rule.