

Note – The latest on disallowance under section 14A

Recently, the Mumbai Bench of the Tribunal in the case of *Reliance Industries Ltd. Vs Addl. CIT [2012] 79 DTR (Trib) 315 (Mum)*, has rendered a very significant judgement relating to disallowance under section 14A of the Income-Tax Act, 1961 (the Act).

The facts in the aforesaid case were that the assessee earned dividend income of Rs.23.78 crores and interest income of Rs.232.81 crores, which were claimed exempt under sections 10(33) and 10(23G) of the Act, respectively. The assessee stated that it had not incurred any expenditure towards the earning of the said exempt income. However, the AO estimated Rs.62.34 crores, being proportionate interest on the borrowed funds and Rs.3.97 crores, being proportionate administrative and other expenses towards earning exempt income and disallowed the same under section 14A of the Act.

In appeal before the CIT(A), it was contended on behalf of the assessee that interest, administrative and other expenses were incurred by the assessee in the normal course of carrying on its business and for maintaining its corporate status . It was also contended that the AO had not demonstrated any nexus between the incurring of the said expenses and the earning of exempt income. It was also contended that assessee's own funds were far greater than its investments and interest-free advances given and it could not be said that any part of the borrowed funds were utilized for making investments. It was thus, contended that no part of interest and administrative and other expenses could be disallowed. The CIT(A) held that the AO had not brought on record any evidence to show that the said expenditure had actually been incurred by the assessee for earning the exempt income. The CIT(A) further stated that it had not been shown that the borrowed funds had been employed for making investments which yielded the interest income and in the absence of any nexus, disallowance made out of interest expenses could not be sustained, particularly when own funds of the assessee company were far in excess of the total amount of investment made. The CIT(A), accordingly, held that the disallowance made under section 14A of the Act out of interest expenditure incurred by the assessee had to be deleted. The CIT(A), however, held that while earning exempt income, some administrative expenditure must inevitably be incurred on the management of portfolio, decision for making investments, bank collection charges, etc. He, however, restricted the disallowance under section 14A to one per cent of the exempt income as was done by his predecessor in the past.

Against the aforesaid decision of the CIT(A), the I.T. Department went in appeal before the Tribunal. The Tribunal held that as the assessee's own funds were far in excess of the investments made by it, which yielded exempt income, it had to be presumed that the investments had come

from interest-free funds available with the assessee and therefore, the disallowance under section 14A made by the AO in respect of interest on borrowings, could not be sustained. Accordingly, the appeal filed by the I.T. Department was dismissed.

While dismissing the appeal of the I.T. Department on the aforesaid issue, the Hon. Tribunal had relied upon the judgement of the Bombay High Court in the case of *CIT Vs Reliance Utilities and Power Ltd. [2009] 313 ITR 340 (Bom) : 18 DTR 1 (Bom)*. It was held in the aforesaid case by the Bombay High Court that if there were funds available both interest-free and over draft and / or loans taken, then a presumption would arise that investments would be out of the interest-free funds generated or available with the company, if the interest-free funds were sufficient to meet the investments and therefore, no part of interest on the borrowings could be disallowed on the basis that investments were out of interest-bearing funds.

Similarly, in the case of *Bunge Agribusiness (India) (P) Ltd. Vs Dy.CIT [2011] 64 DTR (Trib) 201 (Mum)*, it was held that if there were funds available, both interest-free and interest-bearing, then a presumption would arise that interest-free funds have been generated for investments and no disallowance of interest could be made under section 14A.

In this context, it would be appropriate to refer to the provisions of section 14A(2) of the Act. As per section 14A(2), the AO shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under the Act, in accordance with such method as may be prescribed, **if the AO, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to income which does not form part of the total income under the Act.** It is, thus, quite clear that the AO is not required to simply rush to apply the provisions of rule 8D of the Income-Tax Rules, 1962, (the Rules), if in the light of the aforesaid judgements of the Bombay High Court and the Mumbai Bench of the Tribunal, no disallowance of interest is warranted, notwithstanding the provisions of rule 8D, where the assessee's own funds are in excess of the investments made by it which yield exempt income.

In the present context, it may also be appropriate to refer to another judgement on the issue, in the case of *Gillette Group India P. Ltd. Vs ACIT [2012] 16 ITR (Trib) 57 (Del)*. It was held in this case that disallowance under section 14A cannot exceed the expenditure actually claimed by the assessee.

Besides, in the present context, a judgement of Karnataka High Court relating to disallowance under section 14A, in the case of *CCI Ltd. Vs JCIT [2012] 71 DTR 141 (Karn)* is also relevant. It was held in this case that when the assessee had not retained shares with the intention of earning dividend income and the dividend income was incidental to his business of trading in shares, which

remained unsold by the assessee, it could not be said that the expenditure incurred in acquiring the shares has to be apportioned to the extent of dividend income and that should be disallowed from deductions. It was also held that the approach of the I.T. authorities in the aforesaid case was not in conformity with the statutory provisions contained under the Act.

In the light of the aforesaid judgements of the High Courts and the Tribunal, it is advised that the disallowance under section 14A, if any, should be worked out accordingly.

Place : Pune

Date : 27.12.2012

(S.K. Tyagi)

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