Rule 8 D, r.w.s.14A is unjust, arbitrary and ultravires

- By S.K.Tyagi

Section 14A was inserted in the Income Tax Act, 1961 (the Act), by the Finance Act, 2001, with effect from 1.4.1962, in order to clarify, that any expenditure incurred in relation to income not includible in total income will not be allowable as a deduction.

In this regard paragraph (25) of Circular No. 14 of 2001, is relevant. The aforesaid Circular No.14 provides Explanatory Notes on the provisions of Finance Act, 2001, relating to direct taxes, which is printed in 252 I.T.R. (St) 65. Paragraph (25) of the aforesaid Circular is to be found on page 86 thereof. For the sake of ready reference, the aforesaid paragraph (25) is reproduced as follows:

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*25. **No deduction for expenditure incurred in respect of exempt income against taxable income.***

25.1 Certain incomes are not includible while computing the total income, as these are exempt under various provisions of the Act. There have been cases where deductions have been claimed in respect of such exempt income. This in effect 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. This is against the basic principles of taxation whereby only the net income, i.e., gross income minus the expenditure, is taxed. On the same analogy, the exemption is also in respect of the net income. Expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

25.2 Through Finance Act, 2001, a new section 14A has been inserted so as to clarify the intention of the Legislature since the inception of the Income-tax Act, 1961, that no deduction shall be made in respect of any expenditure incurred by the assessee in relation to income which does not form part of the total income under the Income-tax Act.

25.3 It is also being clarified 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.

25.4 This amendment takes effect retrospectively from 1st April, 1962, and accordingly, applies in relation to the assessment year 1962-1963 and subsequent assessment years.

From the aforesaid para 25.2, it may be seen that section 14A has been inserted to clarify the intention of the Legislature since the inception of the Act, that no deduction shall be made in respect of any expenditure incurred by the assessee in relation to income, which does not form part of the total income of the assessee.

Afterwards, sub-sections (2) and (3) were inserted in section 14A by the Finance Act, 2006, with effect from 1.4.2007. As per the aforesaid sub-section (2), it would be mandatory for the Assessing Officer (AO) to determine the amount of expenditure incurred in relation to the exempt income, in accordance with such method as may be prescribed. However, the AO shall follow the prescribed method only, if after having regard to the accounts of the assessee, he is not satisfied with the correctness of the claim of the assessee in respect of expenditure in relation to income, which does not form part of the total income. The provisions of sub-section (2) will also be applicable in relation to a case, where the assessee claims that no expenditure has been incurred by him in relation to income, which does not form part of the total income. In pursuance of the provisions of sub-section (2), the Central Board of Direct Taxes (CBDT) has inserted Rule 8D in the Income Tax Rules, 1962, providing the method for determining the amount of expenditure in relation to income not includible in total income. The aforesaid Rule 8D has been inserted by the I.T.(Fifth Amdt.) Rule, 2008, with effect from 24.3.2008. For the sake of ready reference, the aforesaid Rule 8D is reproduced as follows:

Method for determining amount of expenditure in relation to income not includible in total income.

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).

(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:-

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

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.

In the first place, it may be seen from the provisions of Rule 8D(1) that the Assessing Officer (AO) has to apply the provisions of Rule 8(2), if he 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.

From the aforesaid language of Rule 8D(1), it appears that totally arbitrary powers have been vested with the AO. From the aforesaid provisions, it appears as if the burden of proof in this regard, lies on the assessee. It may be stated in this connection that in the light of the provisions of section 14A, the burden of proof in this regard, must lie on the AO and not on the assessee. In addition, the provisions of Rule 8D(1)(b) are absolutely arbitrary. There may be a case where actually no expenditure has been incurred by the assessee in respect of certain exempt income. Therefore, the application of Rule 8D

will place a huge unwarranted burden on the assessee in the shape of disallowance of huge expenditure, in respect of exempt income, which the assessee has not actually incurred.

Besides, from the aforesaid provisions of Rule 8D(2), it may be seen that the expenditure to be disallowed under section 14A will be the aggregate of the following amounts:

(i) Direct expenditure relating to exempt income.

(ii) A part of expenditure by way of interest, which is not directly attributable to any income or receipt, computed in accordance with Rule 8D(2)(ii).

(iii) An amount equal to 0.5% of the average of the value of investment, income from which is exempt.

From the aforesaid provisions of Rule 8D(2), it may be seen that the method prescribed for the computation of expenditure relating to exempt income, is absolutely unjust, arbitrary and unreasonable. The main reason for this conclusion is that the aforesaid Rule 8D(2) violates the spirit of the provisions of section 14A. Besides, the provisions of Rule 8(2) are in direct conflict with section 14A of the Act, as interpreted in a number of legal precedents.

There are number of judgements of the various Benches of the Tribunal, which have interpreted the provisions of section 14A, and the method provided by Rule 8D for the computation of expenditure relating to exempt income, runs directly contrary to the aforesaid judgements of the Tribunal. The aforesaid judgements are as follows:

1. *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. It was held in this case that-

   (a) The investment in shares and mutual funds was predominantly made by the assessee in earlier years.

   (b) The *finding* of the CIT(A) that the investments made during the relevant previous year were made out of credit balances available in the banks and not by taking loans, has not been challenged or refuted by the Revenue.

   (c) Similarly, interest which is exempt under section10(23G) has been earned on loan advanced in an earlier year.

   (d) Thus, no part of interest cost incurred by the assessee during the relevant year can be related to the earning of dividend and interest income which are exempt under sections 10(33) and 10(23G), respectively.

(e) Therefore, no disallowance can be made under section14A.

(f) As regards indirect management and administrative expenses for earning such income, in the absence of adequate details *ad hoc* estimation of the same at Rs. 2 lakhs on the facts of the case is reasonable.

The relevant part of the Head Note on pages 531, 532 and 533 of the Report, is reproduced as follows:-

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In order to apply the provisions of section14A, it envisages two steps: firstly ,the incomes which do not form part of the total income under the Act have to be identified. Secondly, the expenditure which is related to such income has to be identified. 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. The next step is to identify the expenditure, if any, which is relatable to such incomes. Broadly speaking, expenditures incurred "in relation to an income" can be of two types. First category of expenditure are those which are expended directly to earn such income. Second category is of the type, where there does not exist a direct nexus but can be said to be indirectly related to the earning of income. In the instant case, the funds have been invested by the assessee to earn dividend and interest income. If any funds invested have come out of the interest-bearing borrowings, such interest cost would be a direct expenditure. Whereas the common managerial expenses, viz. salary of employees looking after investment portfolio, office overheads, etc., are expenses which can be considered as indirect expenses.

Insofar as the interest cost on the dividend yielding investment is concerned, there is no material to negate the fact position brought out by the assessee. According to the assessee, the investments in shares and mutual funds have been predominantly made in the earlier years. In relation to the investments made during the previous year relevant to the assessment year in question, the CIT(A) in her order concludes that "it has been confirmed during course of appellate proceedings that the investments have been made from the credit balance available in the banks and not by taking loans". This finding has not been challenged or refuted by the Revenue. Similarly, it is factually not disputed that the interest considered exempt under section10(23G) has been earned on loan advanced in an earlier year. Thus, it can be safely deduced that out of the interest cost incurred by the assessee during the year under

consideration, nothing can be said to be related to earning of the dividend and interest income considered exempt under sections 10(33) and 10(23G), respectively.

Ostensibly, 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. Thus, an estimation is required to ascertain expenditures which have a relation to the earning of dividend and interest incomes considered exempt. ***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 made by the AO is on a thumb rule basis. The AO 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. The mechanical application of such a principle would only lead to distorted picture. The assessee is in the business of manufacture of motorcycles, tractors, etc. Its business is not that of a finance company. The interest received is also in respect of a loan advanced to a subsidiary company in earlier years. Taking into consideration the above aspects, the addition sustained by the CIT(A)is excessive. An ad hoc addition of Rs.2 lakhs would meet the ends of justice.* [Emphasis added]

Conclusion:

Investment in shares and mutual funds was predominantly made by the assessee in earlier years and no investment was made out of borrowings in the relevant year, and the interest-yielding loan was advanced in an earlier year, and therefore no part of interest cost incurred by the assessee during the relevant year can be related to earning of dividend and interest income which are exempt under sections 10(33) and 10(23G), respectively and therefore, no disallowance can be made under section14A; in the absence of separate accounts by which management and administrative expenses attributable to earning of dividend and interest income can be segregated, same are estimated at Rs.2 lakhs on ad hoc basis on consideration of relevant facts.

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2. *Dhanlakshmi Bank Ltd. Vs. ACIT [2007] 12 SOT 625 (Coch.)*

One of the issues before the Hon. Tribunal was disallowance of expenditure under section14A of the Act. 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 was exempt under section 10 of the Act. The AO, by invoking the provisions of section14A, disallowed proportionate expenditure, which as per the AO, was incurred for earning interest-income on tax-free bonds and dividend income.

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 indivisible one, the method adopted by the AO for making the disallowance was not a permissible method and therefore, the AO was not justified in making the disallowance in question.

The relevant part of the Head Note on page 627 of the Report, is reproduced as follows:-

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Before the introduction of section14A, the Apex Court has dealt with the similar issue in the case of Rajasthan State Warehousing Corpn. Vs. CIT [2000] 242 ITR 450 / 109 Taxman 145. In the said case also, the Assessing Officer had made disallowance of the expenditure which was referable to the non-taxable income, being exempt under section 10(29). As per the principles laid down by the Apex Court, in the case of Rajasthan State Warehousing Corpn. (Supra), if the business carried on by the assessee constitutes one indivisible business, then the entire expenditure would be a permissible deduction and apportionment of the expenditure is not permissible. [Paras 10 and 11]

After the judgement of the Apex Court, in the case of Rajasthan State Warehousing Corporation (Supra), section 14A, was brought on the statute book. Thus, the principles for disallowance of the expenditure relating to the exempt or non-taxable income were already there, but the said position has been made clear by virtue of introduction of section 14A. It means that the principles laid down by the Apex Court, in the case of Rajasthan State Warehousing Corpn. (Supra), still hold good, in law, in respect of the introduction of section 14A, governing the disallowance of the expenditure which is incurred for earning tax-free income or in other words income which does not form part of the total income. **Moreover, the ratio decidendi of Rajasthan State Warehousing Corpn. (Supra) could not be nullified even after introduction of section 14A, that if the business of the assessee is indivisible one, then no disallowance can be made on proportionate basis and entire expenditure is allowable.[Para 12]**

In the instant case, the assessee was having the indivisible business and considering the nature of the business of the assessee the investment in the tax-free bonds or investment in the shares might be in the nature of stock-in-trade. There was no identity in respect of the funds applied for

investment in tax-free bonds or shares and funds which were applied for earning taxable income. [Para 13]

The Assessing Officer had adopted the method which was not prescribed as per the provisions of sub-section (2)of section 14A. Moreover, unless the method for working out disallowance of the expenditure in case of an indivisible business is prescribed, as provided in sub-section (2) of section 14A, no disallowance is permissible. Therefore, inspite of the introduction of section 14A, the principles laid down by the Apex Court, in the case of Rajasthan State Warehousing Corpn.(Supra), still hold good law and as there was no clear identity in respect of the funds applied by the assessee for making the investment for earning the tax-free income as well as taxable income and as the assessee's business was indivisible one, the method adopted by the Assessing Officer for making the disallowance was not a permissible method and the Assessing Officer was not justified in making the disallowance in question. The impugned disallowance was, therefore, not justified and the addition made by the Assessing Officer was to be deleted. (Para 14)[Emphasis added]

It is, thus, clear that even after the insertion of section 14A in the Income-Tax Act, 1961, the principles laid down by the Apex Court in the case of *Rajasthan Ware Housing Corporation* are not nullified and therefore, if the business of the assessee is indivisible one, then no disallowance can be made on proportionate basis and entire expenditure is allowable.

3. *Wimco Seedlings Ltd. Vs. Dy. CIT (Asst.) [2007] 293 ITR(AT) 216 (Del.)(TM)*

In the first place, it must be understood here that the weightage of a Third Member judgement is the same as that of a Special Bench of the Tribunal consisting of three members.

The issue in this case was disallowance of expenditure under section 14A. It was held in this case that in respect of a composite activity giving rise to taxable and non-taxable receipts, only expenditure factually incurred on non-taxable receipts is to be disallowed. Expenditure assumed or deemed to be incurred on non-taxable receipts cannot be disallowed.

It was also held in this case that the burden or onus lies on the AO to prove the nexus between the expenditure to be disallowed and non-taxable receipts.

The relevant part of the Head Note on pages 216 and 217 of the Report, is reproduced as follows:-

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Only expenditure which has been proved to have been incurred in relation to the earning of tax-free income can be disallowed under section 14A of the Income-Tax Act 1961. The word "incurred" refers to the factual spending of the expenditure in relation to the exempt income and does not refer to a deemed or assumed spending for the purpose. The section was brought to nullify the effect of certain rulings to the effect that where there is both activity which brings in taxable income and activity which brings in tax-free income and both activities constitute an indivisible business, the expenditure incurred by the assessee for the purposes of the indivisible business cannot artificially be broken up to identify and disallow expenditure which is supposed to have been incurred for the purpose of earning the exempt income. **However, while applying the section there is no authority conferred by the section upon the Assessing Officer to deem or assume certain expenditure to have been incurred in relation to the tax-free income**. *Common expenditure incurred at the head office cannot be broken up artificially to attribute or apportion a part thereof to the earning of the tax-free income on the assumption that such part of the common expenditure was incurred in relation to the tax-free income. Not only the incurring of the expenditure but also its relation to the exempted income must be clear and must be capable of being ascertained on the face of it without involving any further mental exercise.* **The burden is on the Assessing Officer not only to show that some expenditure was factually incurred but also to show its relationship with the income exempt from tax**. *The section only permits the Assessing Officer, in an indivisible business consisting partly of taxable activities and partly of tax-free activities, to identify expenditure, if any, incurred in relation to the earning of non-taxable income and disallow it.* **The section cannot be taken beyond this to attribute, by some yardstick, every item of expenditure which has no apparent connection or nexus with the earning of tax-free income, to the earning of tax-free income.** [Emphasis added]

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4. *Zuari Industries Ltd. Vs. ACIT [2007] 108 TTJ 140 (Mum.)*

In this case one of the issues before the Hon. ITAT, was disallowance of expenditure under section 14A of the Act.

It was held in this case that when the major part of investment came out of the sale proceeds of assessee's one unit and there was no material on record to prove that any interest was paid for

earning tax-free income under section 10(33), and accordingly, no disallowance could be made by invoking section 14A.

5. *ACIT Vs. Eicher Ltd. [2006] 101 TTJ 369 (Del.)*

In this case also, one of the issues before the Hon. Tribunal was disallowance under section 14A in respect of expenses towards dividend income exempt under section 10(33) of the Act. It was held that expenditure which the AO seeks to disallow under section 14A should be actually incurred and so incurred with a view to producing non-taxable income**. It is the duty of the AO to pin point such expenditure on the basis of material on record. There being no material with the AO to show that any expenditure was incurred in earning dividend income, nothing could be disallowed under section 14A on estimate basis.**

The relevant part of the Head Note on pages 371 and 372 of the Report, is reproduced as follows:-

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A look at the language of section 14A shows that the AO can disallow only expenditure 'incurred' by the assessee in relation to the exempt income. The word 'incurred' clearly implies that it must be shown as a fact that some expenditure was in fact incurred by the assessee to produce exempted income. It was open to the legislature to confer power upon the AO to assume that a part of the expenditure must have necessarily been incurred to produce exempted income which the AO can estimate and disallow and accordingly use suitable expressions in the section conferring such power upon the AO. One such instance is section 38(2) which gives the power to the AO to restrict certain deductions under sections 30, 31 and 32 "to a fair proportionate part thereof which the AO may determine having regard to the user of such building, machinery, plant or furniture for the purposes of the business or profession". Another such instance is of section 40A(2)(a) which gives power to the AO to determine, based on his own opinion, as to how much expenditure incurred by the assessee in respect of which payment is made to closely related persons or concerns, is excessive or unreasonable having regard to the fair market value of goods, services or facilities for which the payment is made or the legitimate needs of the business or the benefit derived by the assessee from the expenditure. **But, when section 14A has not given such specific power to the AO, he has no authority to estimate the expenditure which the assessee would have, in the opinion of the AO incurred in relation to the exempted income**. *The words "in relation to" income which is exempt under the Act, no doubt, appear to be broad at first impression, but on deeper examination, and read in conjunction with the word "incurred", it seems that these are restrictive words, restricting the power of the AO to estimate a part of the expenditure incurred by*

the assessee as relatable to the exempted income. It seems that implicit in the expression "in relation to" is the concept that the AO should be in a position to pin point, with an acceptable degree of accuracy, the expenditure which was incurred by the assessee to produce non-taxable income. The word "incurred" signifies that the expenditure must have been actually incurred, not notionally. Reading both the above mentioned expressions together, the conclusion seems inescapable that the expenditure which the AO seeks to disallow under section 14A should be actually incurred and so incurred with a view to producing non-taxable income. **If this much is clear from the section, it follows that it is the duty of the AO to pin point such expenditure on the basis of the material on record**. *Sec.14A only removes the disability on the part of the AO to disallow such expenditure, a disability to which he was subjected by the three judgements of the Supreme Court. The mere removal of the disability statutorily, however does not ipso facto authorize him to assume that a part of the expenditure has been incurred by the assessees in relation to the exempted income and to proceed to disallow the same on estimate.* **The section does not relieve the AO of the burden of proving, on the basis of evidence or material on record that the assessee has in fact incurred the expenditure which has relation to the exempted income.** *There is no dispute that the entire dividend of Rs.83,02,635 which is exempt under section 10(33)was received from EM Ltd. by a single dividend warrant and no effort or expenses were necessary or were incurred to earn such income.* **There is also no material brought to show that the assessee's contention that no part of the interest can be attributed to the earning of the dividend income since the shares were acquired from the own funds in the earlier years and not from borrowed funds, is factually incorrect**. *In these circumstances, there is no material on the basis of which the AO would estimate and disallow a sum of Rs.5 lakhs by invoking section 14A. Only actual expenditure incurred by the assessee to earn exempted income can be disallowed by the AO under section 14A.* [Emphasis added]

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6. *Maruti Udyog Ltd. Vs. Dy. CIT [2005] 92 TTJ 987 (Del.)*

In this case also one of the issues before the Hon. Tribunal was disallowance under section 14A in respect of interest on amount invested in shares of other companies.

It was held that the assessee having interest-free funds far in excess of amount invested in shares of other companies, no disallowance could be made under section 14A on the ground the interest-bearing funds were, invested in earning tax-free dividends. It was also held that the **onus is on the**

Revenue to prove that interest paid by the assessee on borrowed funds related to acquisition of shares yielding tax-free income.

7. *Dy.CIT Vs. BSES Ltd. [2008] 113 TTJ 227 (Mum.)*

   In this case also, one of the issues before the Hon. Tribunal was disallowance under section 14A in respect of interest expenses in relation to tax-free income by way of dividends and interest on tax-free bonds. The AO apportioned interest expenses in the ratio of tax-free income and total turnover and disallowed the same under section 14A.On appeal, the CIT(A) estimated that expenses on earning tax-free income at 0.5 per cent of tax-free income.

   It was held that nothing was brought on record to show any nexus between interest expenditure and tax-free income. Moreover, expenses for earning dividend cannot be a fixed percentage of dividend income even in the cases where, such expenses are incurred. **Expenses, if any, incurred for earning dividend income do not vary with the rate of dividend declared by the companies.** Therefore, disallowance under section 14A was not sustainable.

   In this case, the judgement of the Special Bench of the Tribunal in *Punjab State Industrial Development Corporation Ltd. Vs. Dy. CIT [2006] 103 TTJ 364 (Chd.)(SB) w*as relied upon. In the aforesaid case, the issue before the Special Bench was deduction under section 80M of the Act.

   It was held in this case that for purposes of deduction under the head '*Other sources*', expenses must have nexus to the earning of income and should have been spent with the object of making or earning such income. Therefore, there is no justification to deduct expenses on estimate basis or in proportion to receipts shown by the assessee from various sources. The AO has not placed any material on record to controvert or reject the contention of the assessee that no expenditure was incurred for earning dividend income. Thus, there was no justification on the part of the AO to deduct proportionate management expenses or interest or other expenses while computing dividend income for the purpose of allowing deduction under section 80M of the Act.

8. *Space Financial Services Vs. ACIT [2008] 115 TTJ 165 (Del.)*

   It was, *inter alia*, held in this case that proportionate expenditure could not be attributed to earning of dividend income, without establishing nexus thereto and therefore, the same could not be disallowed under section 14A of the Act.

9. *Kankhal Investments and Trading Company Pvt. Ltd. Vs. ACIT [2008] 301 ITR (AT) 359 (Mum.)*

   It was, *inter alia*, held in this case that disallowance of expenditure on exempt income, on *ad hoc* basis, is not permissible under the provisions of section 14A of the Act.

10. *ACIT Vs. Jindal Shaw Pipes Ltd. [2008] 118 TTJ 228 (Del.)*

It was, *inter alia*, held in this case that **only direct expenses incurred in earning exempt income attract disallowance under section 14A of the Act.** The AO was not justified in disallowing interest on borrowed capital under section 14A, by estimating the same on proportionate basis, on the assumption that such borrowed capital might have been invested in shares, which earned dividend income, exempt under section 10(33) of the Act, more so, when the assessee had interest-free funds, far outweighing such investment and there was no proof that interest-free funds were utilized for purposes other than business.

The relevant part of the Head-Note on pages 231 and 232 of the Report is reproduced as follows :

Held : *Sec. 14A has codified well-settled legal principle that expenditure in relation to earning tax-free income is not an allowable item. Therefore, even in the absence of a new section 14A, the law was well-settled on the issue. It may be important to know that Explanatory Memorandum clearly states that this new provision was only clarificatory in nature. The newly inserted section 14A has used the phrase "expenditure incurred in relation to income not includible in total income', which implies that even the statute contemplates some kind of single 'nexus' between expenses which may be disallowed and the exempted income.* ***From a plain reading of section 14A and the Explanatory Memorandum thereto, it would be clear that only the direct expenses incurred for earning an income which is exempt from tax will be covered by the new section.*** *Interest-free fund available with the assessee company at the beginning of the financial year as also at the close of the relevant assessment year exceeded the funds invested in shares / interest free loans and advances given to the group companies. Interest free fund as on 31st March, 2002 was to the tune of Rs.223.36 crores as against investment in shares and interest free loans and advances to the subsidiary companies at Rs.152.12 crores, (Rs.84.76 crores + Rs.67.36 crore), which is less than its interest free funds. Further, the question of considering loans of Rs.49.07 crores (except Rs.3.88 crores) does not arise as interest has been charged thereon. Similarly, regarding investment in shares to the extent of Rs.14.67 crores also, the question does not arise, as income earned therefrom is not exempt. The net amount of investment to be considered is Rs.141.33 crores as worked out in the CIT(A)'s order.* ***It is further observed that borrowed funds obtained by the appellant were for specific business purposes and the Revenue failed to give clear findings that such funds were not used for the purposes of the business, for which the same were borrowed but used for making investment in shares or for giving loans to group companies.*** *The total*

assets of the company as on 31st March, 2002, as per balance sheet stood at Rs.605.33 crores, as highlighted in the impugned appellate order. The investment / interest free loans and advances out of it stood at Rs.141.33 crores. If this is reduced from the total assets, the business assets / investment as on 31st March, 2002 would be Rs.464 crores, which is more than interest-bearing funds of Rs.358.83 crores. The AO applied the ratio of funds, i.e., interest free funds and borrowed funds to the total funds available and worked out the interest on this presumption that interest bearing funds might have also been used for such investment and loans to group companies. The Revenue failed to substantiate such contention by way of corroborative factual findings. It is further added that interest free advances to subsidiary and other companies and investment in shares of group / subsidiary companies have been made out of interest free funds available with the assessee, has been accepted in the past and no disallowance was made out of interest expenses. The AO failed to establish nexus between the interest-bearing funds and the investment on loans and advances to the group companies. Further, the AO has failed to quantify the expenditure "incurred" by the assessee within the meaning of section 14A. It is important to know that Explanatory Memorandum clearly states that the new provision was only clarificatory in nature. ***The word 'incurred' clearly implies that it must be shown as a fact that some expenditure was in fact incurred by the assessee to produce exempted income. The newly inserted section 14A has not conferred specific powers on the AO to estimate the expenditure which the assessee would have, in the opinion of the AO, incurred in relation to the exempted income.*** *There must exist nexus between the expenditure incurred and the exempted income. The expression "in relation to" is the concept that the AO should be in a position to pinpoint, that the expenditure was incurred by the assessee to produce non-taxable income. In the case, the AO has failed to do so, as notional expenditure has been estimated based on certain assumed fact-situation. There is no reason to interfere with the findings of the CIT(A), deleting the disallowance. – Asstt. CIT vs. Eicher Ltd. (2006) 101 TTJ (Del) 369, Wimco Seedlings Ltd. vs. Dy .CIT (2007) 109 TTJ (Del) (TM) 462 : (2007) 107 ITD 267 (Del)(TM) and S.A. Builders Ltd. vs. CIT (2006) 206 CTR (SC) 631 : (2007) 288 ITR 1 (SC)* ***relied on.*** [Emphasis added]

Summary of the aforesaid judgements.

The salient points of the aforesaid judgements may be summarized as follows :

(i) Only direct expenditure actually incurred on non-taxable receipts, will be covered by section 14A of the Act. Expenditure assumed or deemed to be incurred on non-taxable receipts cannot be disallowed.

(ii) Section 14A has not conferred specific powers on the AO to estimate the expenditure which the assesseee would have, in the opinion of the AO, incurred in relation to exempted income.

(iii) The burden or onus lies on the AO to prove the nexus between the expenditure to be disallowed and non- taxable receipts.

(iv) Section 14A does not absolve the AO of the burden of proving, on the basis of positive evidence or material on record, that the assessee has in fact incurred the expenditure, which has nexus with the exempted income.

(v) Thus, it is the duty of the AO to pinpoint such expenditure on the basis of the material on record.

(vi) Investments made in earlier years fall outside the purview of the provisions of section 14A of the Act.

(vii) Only the investments made during the relevant previous year can be considered for disallowance, under section 14A of the Act.

(viii) If the interest-free funds available with the assessee are more than the impugned investments, then no disallowance can be made under section 14A of the Act.

(ix) Expenses for earning dividend cannot be a fixed percentage of dividend income, even in the case where such expenses are incurred. Expenses, if any, incurred for earning dividend income do not vary with the rate of dividend declared by the companies. In support of this proposition, reliance is placed on the judgement of the Special Bench of the Tribunal in the case of *Punjab State Industrial Dev. Corpn. Ltd. (Supra).*

(x) The *ratio decidendi* of the judgement of the Apex Court in *Rajsthan State Warehousing Corpn. Vs. CIT [2000] 242 ITR 450 (S.C.)* could not be nullified even after the introduction of section 14A, that if business of the assessee is indivisible one, then no disallowance can be made on proportionate basis and entire expenditure is allowable.

Impact of the aforesaid judgements on the validity of Rule 8D

From the aforesaid summary of the various judgements of the Tribunal, it is absolutely clear that the method prescribed by the CBDT, vide Rule 8D for the determination of expenditure relating to exempt income, is directly in conflict with the provisions of section 14A, as interpreted by the various Benches of the Tribunal.

In this connection, it may be stated that, if a Rule of the Income-Tax Rules, 1962 comes into conflict with the provisions of the section of the Income Tax Act, 1961, such Rule will be *ultra vires.* In support of the aforesaid proposition, reliance is placed on the following judgements:

(i) CIT Vs S Chenniappa Mudaliar [1969] 74 ITR 41 (SC)

(ii) CIT Vs Minerva Maritime Corporation [1985] 155 ITR 258 (Bom)

Conclusion

In the light of the reasons stated in the preceding paragraphs, it is absolutely clear that the provisions of the newly inserted Rule 8D are absolutely unjust, arbitrary and unreasonable, because the application of the aforesaid Rule will lead to disallowance of huge expenditure under section 14A, which the assessee has not actually incurred.

In this context, it is also significant to note that the aforesaid judgements of the Tribunal, interpreting the provisions of section 14A of the Act, are in direct conflict with the provisions of the aforesaid Rule 8D.

As the provisions of Rule 8D are in conflict with the relevant section, viz. section 14A of the Act, Rule 8D is to be held as *ultravires.*

Now there may be two alternative remedies for correcting the aforesaid anomalous situation, viz :

(i) The CBDT amends the provisions of Rule 8D, so as to bring it in line with the provisions of section 14A, as interpreted by the various Benches of the Tribunal; or

(ii) The aforesaid Rule 8D is challenged in a writ before a High Court.

I sincerely hope that the CBDT will take notice of the aforesaid anomalies in Rule 8D vis-à-vis the provisions of section 14A of the Act and take adequate steps to remove the same.

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