A Fresh look at disallowance under section 14A of the Income-Tax Act, 1961

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Section 14A, the heading of which is '*Expenditure incurred in relation to income not includable in total income*', was inserted in the Income-Tax Act, 1961 (the Act), by the Finance Act, 2001. As per Circular No.14 of 2001 [*252 ITR (St.) 65*], issued by the CBDT, a new section 14A was inserted, so as 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, under the Act. The provisions of section 14A were, accordingly, made effective, retrospectively from 1.4.1962. Thus, the provisions of section 14A were made applicable in relation to assessment year (AY) 1962-63 and subsequent AYs.

It was also clarified in the aforesaid Circular that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

Thereafter, section 14A was amended by the Finance Act, 2006, with effect from 1.4.2007. Vide the aforesaid amendment, sub-sections (2) and (3) were added in section 14A of the Act. The aforesaid amendment was explained, vide para (11) of Circular No.14 of 2006 [*288 ITR (St.) 9*], dated 28.12.2006. It has been explained in the aforesaid para (11) of the Circular that as in the existing provisions of section 14A, no method of computing the expenditure incurred in relation to income, which does not form part of the total income, had been provided, there was considerable dispute between the tax-payers and the Department on the method of determining such expenditure. It is further explained in the aforesaid para (11) of the Circular that in view of the aforesaid reasons, a new sub-section (2) was inserted in section 14A, so as to provide that it would be mandatory for the Assessing Officer (AO) to determine the amount of expenditure incurred, in relation to such income, which does not form part of the total income, in accordance with such method as may be prescribed. **It is further clarified that the AO shall follow the prescribed method if, 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.** It is also clarified therein that the provisions of sub-section (2) will also be applicable in relation to a case, where an assessee claims that no expenditure has been incurred by him, in relation to income which does not form part of the total income.

Thereafter, rule 8D was inserted in the Income-Tax Rules, 1962 (the Rules), with effect from 24.3.2008. In rule 8D(1) also, it has been provided that where the AO, 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).

From the aforesaid provisions of section 14A(2), rule 8D(1), as also para (11) of Circular No.14 of 2006, dated 28.12.2006, it has been made absolutely clear that the AO shall apply the prescribed method as laid down in rule 8D(2) only if, having regard to the accounts of the assessee, he is not satisfied with the correctness of the claim of the assessee, in respect of the expenditure in relation to income which does not form part of the total income.

Unfortunately, the AOs have not been paying any attention to the aforesaid provision and they have been indiscriminately applying the prescribed method laid down under rule 8D(2) in all the cases, where disallowance under section 14A of the Act, is sought to be made.

In view of the aforesaid approach of the AOs, gross injustice continues to be done in a number of cases, where the provisions of section 14A are found to be applicable.

In this context, it may also be noted that regarding the interpretation of section 14A, there is a plethora of case-law rendered by various Benches of the Income-Tax Appellate Tribunal (ITAT), as also some High Courts and the Supreme Court. In the aforesaid legal precedents, there has often been a divergence of views expressed by the various legal fora.

Sometime back, the Punjab and Haryana High Court had rendered a judgement in respect of section 14A, in the case of *CIT Vs Hero Cycles Ltd. [2010] 323 ITR 518 (P&H) : [2010] 189 Taxman 50 (P&H).* Thereafter, the Supreme Court has also made certain observations in respect of the provisions of section 14A, in the case of *CIT Vs Walfort Share and Stock Brokers P. Ltd. [2010] 326 ITR 1 (SC).* Later on, the Bombay High Court has considered the provisions of section 14A in detail, in the case of *Godrej and Boyce Mfg. Co. Ltd. Vs Dy.CIT [2010] 328 ITR 81 (Bom).*

In spite of the aforesaid plethora of case-law on the provisions of section 14A of the Act, there continues to be a lot of confusion, in relation to the correct interpretation of the provisions of section 14A of the Act, amongst the legal fraternity, as also the legal fora.

In the light of the aforesaid reasons, there is an urgent need to have a fresh look at the provisions of section 14A of the Act, keeping in view the aforesaid legal precedents rendered by the Supreme Court, High Courts and various Benches of the ITAT.

In order to achieve the aforesaid objective, it would be appropriate to first broadly examine the aforesaid judgement of the Apex Court, in the case of *Walfort Share and Stock Brokers P. Ltd.*, the judgement of Punjab and Haryana High Court, in the case of *Hero Cycles Ltd.* and the judgement of the Bombay High Court, in the case of *Godrej and Boyce Mfg. Co. Ltd.* The aforesaid judgements are broadly examined as follows :

(A) *CIT Vs Walfort Share and Stock Brokers P. Ltd. [2010] 326 ITR 1 (SC).*

In this case, the Hon. Supreme Court has*, inter alia*, dealt with the provisions of section 14A of the Act. It has been held in this case that **section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income**. It is also laid down in this case that for attracting section 14A, there has to be an approximate cause for disallowance which is in relationship with the tax-exempt income.

(B) *CIT Vs Hero Cycles Ltd. [2010] 323 ITR 518 (P&H*

In this case, the asessee was engaged in the manufacture of cycles and parts of two wheelers in multiple units. It earned dividend income, which was exempted under sections 10(34) and (35) of the Act. The AO made enquiry whether any expenditure was incurred for earning this income and as a result of the enquiry made, addition by way of disallowance under section 14A(3) was made. The aforesaid disallowance was partly upheld by the CIT(A).

However, the Tribunal held that there was no nexus between the expenditure incurred and the income generated. Therefore, it held that merely because the assessee had incurred interest expenditure on funds borrowed in the main unit, it would not *ipso facto* invite the disallowance under section 14A, unless there was evidence to show that such interest bearing funds had been invested in the investments which had generated the '*Tax exempt dividend income'*.

On further appeal by the Department, dismissing the appeal, it was held by the High Court that the expenditure on interest was set-off against the income from interest and the investment in the shares and funds were made out of the dividend proceeds. In view of this finding of fact, disallowance under section 14A was not sustainable. Whether, in a given situation, any expenditure was incurred which was to be disallowed, was a question of fact.

It was also held that the contention of the Revenue that directly or indirectly some expenditure was always incurred, which must be disallowed under section 14A and the impact of expenditure so incurred could not be allowed to be set-off against the business income, which may nullify the mandate of section 14A; could not be accepted.

It is significant to note in this context that in this case, the Hon. High Court had also considered the provisions of section 14A(2), r.w.r.8D(1)(b) of the Rules. It may be stated in this context that it was contended on behalf of the Department that as per section 14A(2) and rule 8D(1)(b), even where the assessee claimed that no expenditure had been incurred, the correctness of such claim could be gone into by the AO and in the present case, the claim of the assessee that no expenditure was incurred was found to be not acceptable by the AO and thus, disallowance was justified. The aforesaid contention of the Department was also found to be unacceptable by the Hon. High Court.

(C) *Godrej and Boyce Mfg. Co. Ltd. Vs Dy.CIT [2010] 328 ITR 81 (Bom)*

It has been, *inter alia*, held in this case that section 14A(1) is enacted to ensure that only the **expenses incurred in respect of earning taxable income are allowed.** In addition, the Hon. Bombay High Court has also laid down the following very significant principles regarding the provisions of section 14A(2) of the Act :

(i) Sub-section (2) of section 14A was inserted so as to provide a uniform method applicable **where the AO is not satisfied with the correctness of the claim of the assessee**.

(ii) The invocation of the power of AO is made conditional on the objective satisfaction of the AO, in regard to the correctness of the claim of the assessee, having regard to the accounts of the assessee.

(iii) These safeguards which are implicit in the requirement of fairness and fair procedure under Article 14 must be observed by the AO when he arrives at a satisfaction under sub-section (2) of section 14A.

(iv) Sub-rule (1) of rule 8D of the Income-Tax Rules, 1962, has also incorporated the essential requirement of sub-section (2) of section 14A, before the AO proceeds to apply the method prescribed under sub-rule(2).

(v) For the purpose of section 14A, the AO is duty-bound to determine the expenditure which has been incurred in relation to income which does not form part of the total income under the Act.

(vi) The AO must adopt a reasonable basis or method consistent with all the relevant facts and circumstances after furnishing a reasonable opportunity to the assessee to place all germane material on the record.

From the aforesaid principles laid down by the Bombay High Court, it is quite clear that the method prescribed under rule 8D, for the disallowance of expenditure under section 14A, will be applicable only where the AO is not satisfied with the correctness of the claim of the assessee. It is also laid down that the invocation of the power of the AO is made conditional on the objective satisfaction of the AO, in regard to the correctness of the claim of the assessee, having regard to the accounts of the assessee. In this context, it is further laid down that the aforesaid safeguard is also provided, vide rule 8D(1) of the Rules.

In this context, it is also significant to note that while laying down the aforesaid principles, the Hon. Bombay High Court has placed reliance on the aforesaid judgement of the Apex Court, in the case of *Walfort Share and Stock Brokers P. Ltd.*

In the present context, it will also be necessary to refer to numerous legal precedents laid down by the various Benches of the Tribunal in a number of cases, which will be discussed hereinafter, wherever relevant.

On the basis of the aforesaid judgements of the Apex Court, Punjab and Haryana High Court and Bombay High Court, as also the judgements of various Benches of the Tribunal, the following principles will emerge, as regards the correct interpretation of the provisions of section 14A of the Act, along with rule 8D of the Rules :

(i) Section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

(ii) Rule 8D, r.w.s.14A(2) can be invoked only 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 expenditure incurred, in relation to the tax-free income.

(iii) The onus is on the Department to prove that any expenditure was incurred for earning tax-free income, and

(iv) Only the direct expenses incurred for earning an income whish is exempt from tax, will be covered under the provisions of section 14A.

The aforesaid legal principles in relation to the interpretation of the provisions of section 14A, along with rule 8D, are discussed in detail as follows :

1. Section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

In this context, it may be stated that the Hon. Apex Court, in the case of *CIT Vs Walfort Share and Stock Brokers P. Ltd. [2010] 326 ITR 1 (SC),* has clearly laid down that section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

Similarly, the aforesaid principle, though indirectly, has also been supported by the judgement of the Punjab and Haryana High Court, in the case of *CIT Vs Hero Cycles Ltd. [2010] 323 ITR 518 (P&H).* It has been clearly held in this case that disallowance under section 14A requires a finding of incurrence of expenditure and where it was found that for earning exempted income, no expenditure had been incurred, disallowance under section 14A could not stand.

Besides, the Bombay High Court, in the case of *Godrej and Boyce Mfg. Co. Ltd. Vs Dy.CIT [2010] 328 ITR 81 (Bom),* by placing reliance on the aforesaid judgement of the Supreme Court, in the case of *Walfort Share and Stock Brokers P. Ltd.*, has reiterated that section 14A(1) is enacted to ensure that only expenses incurred in respect of earning taxable income are allowed.

It may, thus, be seen that while interpreting the provisions of section 14A, emphasis must be placed on the basic principle that only expenses incurred in respect of earning taxable income are allowed. It would clearly imply that only those expenses which have no relation to the earning of taxable income should be considered for disallowance under section 14A of the Act.

In view of the aforesaid reasons, the Department should adopt a different approach, as regards the disallowance of expenditure under section 14A of the Act. In this context, it must be understood that the expenses which an assessee would have to incur for earning the taxable income, even in the absence of the exempt income, should not be brought within the ambit of disallowance under section 14A. In other words, it has to be kept in view that most of the expenses incurred in a business enterprise relate to the normal business activities and in most of the cases, no separate expenses are incurred, for earning the exempt income.

In this regard, it is also relevant to attach due importance to the observations of the Punjab and Haryana High Court, in the case of *Hero Cycles Ltd.*, that the contention of the Revenue that directly or indirectly some expenditure is always incurred for earning exempt income, should not be accepted. In other words, it may be concluded that only the direct expenses incurred for earning the exempt income should be covered under the provisions of section 14A.

In this connection, a reference to the judgement of the Tribunal, in the case of *WIMCO Seedlings Ltd. Vs Dy.CIT [2007] 109 TTJ 462 (Del) (TM)* is also relevant. It has been, *inter alia,* held in this case that 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.

In the light of the aforesaid reasons, the disallowance of expenditure in accordance with the method prescribed under sub-rule (2) of rule 8D, will have a considerably limited scope.

2. **Rule 8D, r.w.s.14A(2) can be invoked only 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 expenditure incurred, in relation to the tax-free income.**

As already pointed out earlier, the AOs have not been paying any attention to the aforesaid provision of section 14A(2), as also rule 8D(1) and they have been indiscriminately applying the method prescribed under rule 8D(2) in all cases, for the purpose of disallowance of expenditure under section 14A of the Act.

The aforesaid approach of the AOs is totally in violation of the spirit of the provisions of section 14A(2) of the Act and rule 8D(1) of the Rules. Frankly speaking, if the AO, correctly follow the aforesaid provisions of section 14A(2) and rule 8D(1), then there will be hardly any cases wherein disallowance of expenditure under section 14A would be called for.

In the light of the aforesaid reasons, the AO must realize that invocation of his power under section 14A and rule 8D is conditional on his objective satisfaction, in regard to the correctness of the claim of the assessee, having regard to the accounts of the assessee. He should also realize that these safeguards are very much implicit in the requirements of fairness and fair procedure, as laid down under Article 14 of the Constitution and the same must be observed by the AO when he arrives at his satisfaction under sub-section (2) of section 14A. The AO must also realize that that sub-rule (1) of rule 8D of the Rules, has also incorporated the essential requirements of section 14A(2), before he proceeds to apply the method prescribed under sub-rule (2) of rule 8D.

In support of the aforesaid stand, reliance is placed on the following legal precedents :

(i) *Godrej and Boyce Mfg. Co. Ltd. Vs Dy.CIT [2010] 328 ITR 81 (Bom)*

It has been clearly held in this case that sub-section (2) of section 14A was inserted, so as to provide a uniform method applicable where the **AO is not satisfied with the correctness of the claim of the assessee.** It is further held that invocation of the power of the AO is made conditional on the objective satisfaction of the AO, in regard to the correctness of the claim of the assessee, having regard to the accounts of the assessee. Besides, it is also held that rule 8D(1) also incorporates the essential requirement of sub-section (2) of section 14A, before the AO proceeds to apply the method prescribed under sub-rule (2) of rule 8D.

(ii) CIT Vs. Hero Cycles Ltd. [2010] 323 ITR 518 (P&H).

It was, *inter alia*, held in this case that disallowance under section 14A requires a finding of incurring of expenditure and where it was found that for earning exempted income, no expenditure had been incurred, disallowance under section 14A could not stand.

(iii) DCIT Vs.Jindal Photo Ltd, ITA No.4539 / Delhi / 2010, AY 2007-08, dated 22.12.2010.

It has been held in this case that rule 8D, r.w.s.14A(2) can be invoked only 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 the expenditure incurred, in relation to tax-free income.

(iv) WIMCO Seedlings Ltd. Vs Dy.CIT [2007] 109 TTJ 462 (Del) (TM)

It was, *inter alia*, held in this case that the AO has to first record a finding that he is not satisfied with the correctness of the assessee's claim regarding such expenditure.

3. The onus is on the Department to prove that any expenditure was incurred for earning tax-free income.

In the present context, it must be clearly understood that under section 14A, only expenditure which has been proved to have been incurred in relation to the earning of tax-free income, can be disallowed and this section cannot be extended to disallow any expenditure which is assumed to have been incurred for the purpose of earning tax-free income. Therefore, the burden of proof or onus in this regard would lie on the AO, not only to show that some expenditure was factually incurred, but also to show its relationship with the income exempt from tax.

In support of this stand , reliance is placed on the following legal precedents :

(i) *WIMCO Seedlings Ltd. Vs Dy.CIT [2007] 109 TTJ 462 (Del) (TM)*

It has been held in this case that burden would lie on the AO not only to show that some expenditure was factually incurred, but also to show its relationship with the income exempt from tax.

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

It was, *inter alia*, held in this case that onus is on the Revenue to prove that interest paid by the assessee on borrowed funds related to the acquisition of shares yielding tax-free income.

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

In this case, reliance was placed on the aforesaid judgement, in the case of *Maruti Udyog Ltd.*, and it was, thus, held that onus is on the Department to prove that any expenditure was incurred for earning tax-free income.

It was further held in this case that there was no material on record to prove that any interest was paid for earning tax-free income and therefore, no disallowance under section 14A was called for.

(iv) *DCIT Vs.Jindal Photo Ltd, ITA No.4539 / Delhi / 2010, AY 2007-08*, dated 22.12.2010.
It was held in this case that the onus is on the AO to establish that expenditure was incurred to earn tax-free income.

(v) *ACIT Vs. Eicher Ltd. [2006] 101 TTJ 369 (Del.).*
It was held in this case that burden is on the AO to establish nexus of expenses incurred with the earning of exempt income, before making any disallowance under section 14A.

4. Only the direct expenses incurred for earning an income whish is exempt from tax, will be covered under the provisions of section 14A.

In this regard, it may be stated that the plain reading of section 14A, as also the Explanatory Memorandum to the Finance Bill, 2001, expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. It has also been explained in the Explanatory Memorandum that the exemption is to be allowed only in respect of the net income. It is, thus, clear that **only direct expenses incurred for earning an income which is exempt from tax, will be covered by section 14A.** In other words, it is only such expenditure which is directly linked to the income which is free from tax that can be subjected to disallowance under section 14A.

In support of the aforesaid stand, reliance is placed on the following legal precedents :

(i) CIT Vs Walfort Share and Stock Brokers P. Ltd. [2010] 326 ITR 1 (SC)
It was held in this case that section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

It impliedly proves that only direct expenses relatable to exempt income, will fall within the mischief of section 14A of the Act.

(ii) Godrej and Boyce Mfg. Co. Ltd. Vs Dy.CIT [2010] 328 ITR 81 (Bom)
In this case also, it was held that section 14A(1) is enacted to ensure that only expenses incurred in respect of earning taxable income are allowed.

It impliedly proves that only direct expenses relatable to exempt income will fall within the mischief of section 14A of the Act.

(iii) ACIT Vs. Jindal Saw Pipes Ltd. [2008] 118 TTJ 228 (Del.)

It has been very clearly held in this case that only direct expenses incurred in earning exempt income would attract disallowance under section 14A.

It has also been held in this case that there must exist nexus between expenditure incurred and exempted income.

(iv) Hero Cycles Vs. JCIT [2009] 20 DTR (Trib.) 213 (Chd.)

It was held in this case that it is only such expenditure which is directly linked to tax-free income, that alone can be subjected to disallowance under section 14A.

(v) DCIT Vs. Maharashtra Seamless Ltd., ITA No.4063 (Del.) 2006 for AY 2003-04, dated 16.12.2010.

It was held in this case that for disallowance of interest on borrowed funds under section 14A, the AO has to establish nexus between borrowed funds and tax-free investment.

(vi) Dy.CIT Vs. B.S.E.S.Ltd.[2008] 113 TTJ 227 (Mum.)

It was held in this case that nothing was brought on record to show any nexus between interest expenditure and tax-free income. Therefore, no disallowance under section 14A was sustainable.

5. Conclusion

In the light of the discussion in the preceding paragraphs (1) to (4), it may be concluded that –

(i) Section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income.

(ii) Rule 8D, r.w.s.14A(2) can be invoked only 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 expenditure incurred, in relation to the tax-free income.

(iii) The onus or burden of proof is on the Department to prove that any expenditure was incurred for earning tax-free income.

(iv) Only the direct expenses incurred for earning an income whish is exempt from tax, will be covered under the provisions of section 14A.

It is hoped that in the light of the aforesaid detailed discussion about the interpretation of the provisions of section 14A of the Act, the Central Board of Direct Taxes (CBDT) will appropriately advise the Assessing Officers that rule 8D should be invoked only if the Assessing Officer, having

regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee, in respect of expenditure incurred in relation to the tax-free income. Besides, the Assessing Officers should also be advised to strictly follow the aforesaid legal principles, while applying the provisions of section 14A of the Act.

In addition, all the tax-payers, chartered accountants and income-tax practitioners are advised to follow the aforesaid guidelines for the purpose of disallowance of expenditure under section 14A of the Act.

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