Disallowance under section 14A – The AO cannot straight away apply rule 8D, without consideration of claim of assessee under section 14A(2) of the Act.

[Published in 358 ITR (Journ.) p. 30 (Part-3)]

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It has been observed that for the purpose of disallowance of expenditure under section 14A of the Income-Tax Act, 1961 (the Act), in respect of income exempt from tax, the Assessing Officers (AOs) have been following a totally erroneous method of straight away applying rule 8D of the Income-Tax Rules, 1962 (the Rules), without considering the correctness of the claim made by the assessee in respect of the expenditure incurred in relation to such income. This tendency has got so much ingrained in the AOs that while making disallowance under section 14A of the Act, they do not pause to consider the implications of section 14A(2) and section 14A(3) of the Act and instead, they straight away proceed to apply rule 8D of the Rules and thereby make totally erroneous and disproportionate disallowance of expenditure under section 14A of the Act. Such a tendency needs to be restrained and curbed, because it causes uncalled for harassment and inconvenience to the assesses, in whose cases disallowance under section 14A is applicable.

In this connection, first of all, it will be appropriate to refer to the provisions of section 14A of the Act, which are reproduced as follows :

"Expenditure incurred in relation to income not includible in total income.

14A. *(1) For the purposes of computing the total income under this 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 this Act.*

(2) The Assessing Officer shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, 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 such expenditure in relation to income which does not form part of the total income under this Act.

(3) The provisions of sub-section (2) shall also apply 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 under this Act :

***Provided** that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001."*

From the aforesaid provisions of section 14A(2) of the Act, it may be seen that unless the AO gives a reasoned finding that the expenditure shown or even not shown in the assessee's accounts is incorrect, he cannot proceed to compute the disallowance as prescribed. In other words, the condition precedent for the AO embarking upon the determination of the amount of expenditure incurred in relation to exempt income, is that the AO must record that he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. It may be further stated that sub-section (3) of section 14A is nothing but an off-shoot of sub-section (2) of section 14A. Sub-section (3) applies to cases where the assessee claims that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act. In other words, sub-section (2) deals with cases where the assessee specifies a positive amount of expenditure in relation to income, which does not form part of the total income under the Act and sub-section (3) applies to cases where the assessee asserts that no expenditure had been incurred in relation to exempt income. In both cases, the AO, if satisfied with the correctness of the claim of the assessee, in respect of such expenditure or no expenditure, as the case may be, cannot embark upon a determination of the amount of expenditure, in accordance with any prescribed method, as laid down in section 14A(2) of the Act.

In order to elaborate and support the aforesaid position of law, in respect of disallowance under section 14A of the Act, it will be necessary to deal with the relevant Explanatory Notes / Circulars issued by the CBDT and relevant legal precedents, in respect of the interpretation of section 14A of the Act. The same are discussed as follows :

I. The purpose of insertion and interpretation of section 14A, as per the CBDT and the Supreme Court.

Section 14A was inserted in the Income-Tax Act, 1961, 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 the total income, will not be allowable as a deduction. The Explanatory Notes issued by the CBDT, including the interpretation by the Supreme Court in respect thereof, are discussed as follows :

1. Memorandum explaining the provisions of the Finance Bill, 2001 – 248 ITR (St) 195 and 196.

In this context, first a reference may be made to the Memorandum explaining the provisions of the Finance Bill, 2001, in respect of the insertion of section 14A in the Act. The relevant part of the Memorandum is to be found in 248 ITR (St), pages 195 and 196. For the sake of ready reference, the same is reproduced as follows :

"No deduction for expenditure incurred in respect of exempt income

against taxable income

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.*

It is proposed to insert a new section 14A 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.

The proposed amendment will take effect retrospectively from 1st April, 1962 and will accordingly, apply in relation to the assessment year 1962-1963 and subsequent assessment years." [Emphasis added]

The aforesaid Memorandum clarifies that as per the basic principles of taxation, only net income, i.e. gross income minus the expenditure is to be taxed. On the same analogy, the exemption is also to be allowed in respect of the net income. Therefore, the expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. It is, thus, quite clear that exemption is also to be allowed in respect of net income, i.e. after deduction from the gross income, the expenditure relatable to the earning of such exempt income.

2. Circular No.14 of 2001, published in 252 ITR (St) 65 and the interpretation of the same by the Supreme Court.

Thereafter, the provisions of section 14A have been again explained in para 25 of Circular No.14 of 2001, as published in 252 ITR (St) 65. In this regard, the observations of the Supreme Court on pages 15 and 16 of the Report, in the case of *CIT Vs Walfort Share and Stock Brokers P.Ltd [2010] 326 ITR 1 (SC)*, are very relevant, which are reproduced as follows :

"*The insertion of section 14A with retrospective effect is the serious attempt on the part of Parliament not to allow deduction 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 against the taxable income (see Circular No. 14 of 2001, dated November 22, 2001). In other words, section 14A clarifies that expenses incurred can be allowed only to the extent they are relatable to the earning of taxable income. In many cases the nature of expenses incurred by the assessee may be relatable partly to the exempt income and partly to the taxable income. In the absence of section 14A, the expenditure incurred in respect of exempt income was being claimed against taxable income.* ***The mandate of section 14A is clear. It desires to curb the practice to claim deduction of expenses incurred in relation to exempt income against taxable income and at the same time avail the tax incentive by way of exemption of exempt income without making any apportionment of expenses incurred in relation to exempt income.*** *The basic reason for insertion of section 14A is that certain incomes are not includible while computing total income as these are exempt under certain provisions of the Act. In the past, there have been cases in which deduction has been*

sought in respect of such incomes which in effect would mean that tax incentives to certain incomes was to reduce the tax payable on the non-exempt income by debiting the expenses, incurred to earn the exempt income, against taxable income. The basic principle of taxation is to tax the net income, i.e., gross income minus the expenditure. On the same analogy the exemption is also in respect of net income. ***Expenses allowed can only be in respect of earning of taxable income. This is the purport of section 14A."*** [Emphasis added]

The Hon. Supreme Court has, thus, come to a conclusion that for attracting section 14A, there has to be a proximate cause for disallowance which is its relationship with the tax exempt income. Thus, in the absence of such proximate cause for disallowance, section 14A cannot be invoked.

3. Para 11 of Circular No.14 of 2006 – 288 ITR (St) 9

Besides, para 11 of Circular No.14 of 2006, dt.28.12.2006, is also relevant in the present context. The aforesaid Circular is published in 288 ITR (St) 9 and the aforesaid para 11 is to be found on page 19 thereof. For the sake of ready reference, the aforesaid para 11 of Circular No.14 of 2006, is reproduced as follows :

" Method for allocating expenditure in relation to exempt income

11.1 *Section 14A of the Income-tax Act, 1961, provides that for the purposes of computing the total income under Chapter-IV of the said 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 Income-tax Act. In the existing provisions of section 14A, however, no method of computing the expenditure incurred in relation to income which does not form part of the total income has been provided for. Consequently, there is considerable dispute between the taxpayers and the Department on the method of determining such expenditure.*

11.2 *In view of the above, a new sub-section (2) has been inserted in section 14A so as to provide that it would be mandatory for the Assessing Officer 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.* ***However, the Assessing Officer 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. *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.*

11.3 *Applicability - From assessment year 2007-08 onwards."* [Emphasis added]

From the aforesaid para 11 of Circular No.14 of 2006, it may be seen that as per section 14A(2), the AO shall follow the prescribed method, if 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. However, as per section 14A(3), the provisions of section 14A(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.

It is, thus, absolutely clear that the AO cannot straight away proceed to apply rule 8D, without considering the correctness of the claim made by the assessee, in respect of expenditure incurred in relation to exempt income.

II. Legal precedents in support of the aforesaid view.

The aforesaid legal position as laid down under sections 14A(2) and 14A(3), is further supported by the following legal precedents :

1. *Godrej and Boyce Mfg.Co.Ltd Vs Dy.CIT [2010] 328 ITR 81 (Bom): 43 DTR 177 (Bom)*

In the first place, we may refer to the principles which, as per the aforesaid judgement, emerge from section 14A and the decision of the Supreme Court, in the case of *CIT Vs Walfort Share and Stock Brokers P.Ltd [2010] 326 ITR 1 (SC).* These observations on page 99 of the Report in 328 ITR, are as follows :

"*The following principles would emerge from section 14A and the decision in Walfort :*

(a) The mandate of section 14A is to prevent claims for deduction of expenditure in relation to income which does not form part of the total income of the assessee;

(b) Section 14A(1) is enacted to ensure that only expenses incurred in respect of earning taxable income are allowed;

(c) The principle of apportionment of expenses is widened by section 14A to include even the apportionment of expenditure between taxable and non-taxable income of an indivisible business;

(d) The basic principle of taxation is to tax net income. This principle applies even for the purposes of section 14A and expenses towards non-taxable income must be excluded;

(e) Once a proximate cause for disallowance is established—which is the relationship of the expenditure with income which does not form part of the total income—a disallowance has to be effected. All expenditure incurred in relation to income which does not form part of the total income under the provisions of the Act has to be disallowed under s. 14A."

From the aforesaid observations, it may be clearly seen that a disallowance under section 14A can be effected only once a proximate cause for disallowance is established, which is the relationship of the expenditure with income which does not form part of the total income.

Further, in this context, the observations of the Hon. High Court, on pages 100-101 of the Report in 328 ITR, are also relevant. The relevant part of the same is reproduced as follows :

"***Hence, sub-section (2) does not ipso facto enable the Assessing Officer to apply the method prescribed by the rules straightaway without considering whether the claim made by the assessee in respect of the expenditure incurred in relation to income which does not form part of the total income is correct.*** *The Assessing Officer must, in the first instance, determine whether the claim of the assessee in that regard is correct and the determination must be made having regard to the accounts of the assessee. The satisfaction of the Assessing Officer must be arrived at on an objective basis. It is only when the Assessing Officer is not satisfied with the claim of the assessee, that the legislature directs*

him to follow the method that may be prescribed. ***In a situation where the accounts of the assessee furnish an objective basis for the Assessing Officer to arrive at a satisfaction in regard to the correctness of the claim of the assessee of the expenditure which has been incurred in relation to income which does not form part of the total income, there would be no warrant for taking recourse to the method prescribed by the rules.*** *For, it is only in the event of the Assessing Officer not being so satisfied that recourse to the prescribed method is mandated by law. Sub-section (3) of section 14A provides for the application of sub-section (2) also to a situation 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 under the Act."* [Emphasis added]

From the aforesaid observations, it may be clearly seen that –

(i) Section 14A(2) does not *ipso facto* enable the AO to apply the method prescribed by the rules straightaway, without considering the correctness of the claim of the assessee, regarding the expenditure incurred in relation to exempt income.

(ii) The satisfaction of the AO in this regard must be arrived at on an objective basis.

(iii) Where the accounts of the assessee furnish an objective basis for the AO to arrive at a satisfaction, in regard to the correctness of the claim, in respect of the expenditure incurred in relation to exempt income, there would be no warrant for taking recourse to the method prescribed by the rules.

It may be further stated here that the phrase "*Accounts of the assessee*" here does not mean that the assessee should separately maintain any books of account, in respect of the impugned expenditure. It only means that the assessee should be in a position to provide rational basis, including the relevant facts and figures, as regards the expenditure incurred by him in relation to exempt income.

2. Maxopp Investment Ltd Vs CIT [2012] 347 ITR 272 (Del) : [2011] 64 DTR 122 (Del)

In this case, the Hon. Delhi High Court was seized with the issue of interpretation of sections 14A(2) and 14A(3), with regard to the applicability of rule 8D of the Rules. As regards the applicability of rule 8D of the rules, vis-à-vis the provisions of section 14A(2)

and 14A(3), the relevant observations of the Hon.High Court are to be found on pages 289, 290 and 291 of the Report in 347 ITR. The aforesaid observations of the Hon.High Court may be summarized as follows :

(i) The expression "*in relation to*" does not have any embedded object. It simply means "*in connection with*" or "*pertains to*". If the expenditure in question has a relation or connection with or pertains to exempt income, it cannot be allowed as a deduction even if it qualifies under other provisions of the Act. The actual expenditure that is in contemplation under section 14A(1) of the Act is the "*actual*" expenditure in relation to or in connection with or pertaining to exempt income**. The corollary to this is that if no expenditure is incurred in relation to the exempt income, no disallowance can be made under section 14A of the Act.**

(ii) Sub-sections (2) and (3) were inserted by the Finance Act, 2006, with effect from April 1, 2007. However, the expression "*such method as may be prescribed*" got meaning only by the introduction of rule 8D of the Income-Tax Rules, 1962.

(iii) Sub-section (2) of section 14A provides the manner in which the Assessing Officer is to determine the amount of expenditure incurred in relation to income which does not form part of the total income. The requirement of the Assessing Officer embarking upon a determination of the amount of expenditure incurred in relation to exempt income would be triggered only if the Assessing Officer returns a finding that he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure. **Therefore, the condition precedent for the Assessing Officer entering upon a determination of the amount of expenditure incurred, in relation to exempt income is that the Assessing Officer must record that he is not satisfied with the correctness of the claim of the assessee in respect of such expenditure.**

(iv) Sub-section (3) is nothing but an offshoot of sub-section (2) of section 14A. Sub-section (3) applies to cases where the assessee claims that no expenditure has been incurred in relation to income which does not form part of the total income under the Act. In other words, sub-section (2) deals with cases where the assessee specifies a positive amount of expenditure in relation to income which does not form part of the total income under the Act and sub-section (3) applies to cases where the assessee asserts that no expenditure had been incurred in relation to exempt income. **In both**

> **cases, the Assessing Officer, if satisfied with the correctness of the claim of the assessee in respect of such expenditure or no expenditure, as the case may be, cannot embark upon a determination of the amount of expenditure in accordance with any prescribed method, as mentioned in sub-section (2) of section 14A of the Act.** It is only if the Assessing Officer is not satisfied with the correctness of the claim of the assessee, in both cases, that the Assessing Officer gets jurisdiction to 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 the prescribed method. The prescribed method is the method stipulated in rule 8D of the Rules. While rejecting the claim of the assessee with regard to the expenditure or no expenditure, as the case may be, in relation to exempt income, the Assessing Officer would have to indicate cogent reasons for the same. It is, therefore, clear that determination of the amount of expenditure in relation to exempt income under rule 8D would only come into play when the Assessing Officer rejects the claim of the assessee in this regard.

In other words, as per the aforesaid judgement, even where the assessee claims that no expenditure has been incurred in relation to income which does not form part of the total income, the Assessing Officer will have to verify the correctness of such claim. In case, the Assessing Officer is satisfied with the claim of the assessee with regard to the expenditure or no expenditure, as the case may be, the Assessing Officer is to accept the claim of the assessee in so far as the quantum of disallowance under section 14A is concerned. In such eventuality, the Assessing Officer cannot embark upon a determination of the amount of expenditure for the purposes of section 14A(1). In case, the Assessing Officer is not, on the basis of the objective criteria and after giving the assessee a reasonable opportunity, satisfied with the correctness of the claim of the assessee, he shall have to reject the claim and state the reasons for doing so. Having done so, the Assessing Officer will have to determine the amount of expenditure incurred in relation to income which does not form part of the total income under the Act.

It will also be relevant to stated in this context that in the aforesaid judgement, the Hon. Del. High Court has extensively referred to the judgement of the Supreme Court, in the case of *CIT Vs.Walfort Share and Stock Brokers P.Ltd [2010] 326 ITR 1 (SC).*

In the light of the aforesaid reasons, it is quite clear that it is only in those cases where the AO is not satisfied with the correctness of the quantum of disallowance made by the assessee under section 14A of the Act, that he is required to compute such disallowance as per the provisions of rule 8D of the Rules. It may also be stated here that for rejecting the correctness of the aforesaid claim of the assessee, the AO will be required to give a reasoned finding that the expenditure or no expenditure disallowed by the assessee, is incorrect.

3. *CIT Vs. Consolidated Photo & Finvest Ltd [2012] 211 Taxman 184 (Del)*

In this case, the assessee incurred some expenditure in relation to earning of exempt income. In the return filed for the relevant assessment year, the assessee itself, made a disallowance of certain amount under section 14A, out of the total expenses incurred by it. The AO, without examining the merit of assessee's stand, straight away proceeded to apply rule 8D of the Rules and disallowed some amount which was much more than the expenditure incurred by the assessee. The CIT(A) deleted the disallowance made by the AO. On appeal, the Tribunal did not find any discrepancy or error in the disallowance made by the assessee and thus, upheld the decision of the CIT(A).

On appeal before the High Court by the IT Department, it was held that it was for the AO to examine whether the disallowance offered by the assessee itself, was sufficient on the facts and circumstances of the case, notwithstanding the view he took regarding the applicability of rule 8D. When the matter reached the Tribunal, the Tribunal specifically called upon the Departmental Representative to pinpoint any error in the computation of the disallowance made by the assessee, but he was not able to pinpoint any error in the same. In the circumstances, no strong ground was made out for disturbing the decision of the Tribunal and accordingly, the decision of the Tribunal was upheld.

It was, thus, clearly held that the AO could not straight away proceed to apply rule 8D, without examining the merits of the assessee's claim, in respect of the expenditure disallowed by it under section 14A of the Act.

4. *Development Credit Bank Ltd Vs Dy.CIT [2013] 26 ITR (Trib) 209 (Mum)*

One of the issues before the Hon.Tribunal in this case was disallowance under section 14A. In this context, the provisions of section 14A(2), as well as rule 8D have been discussed in detail.

In this case, the assessee during the year under consideration, computed the disallowance under section 14A *suo motu*, at Rs.15,84,000. The AO, applying rule 8D, computed the disallowance at Rs.10,09,11,791. On appeal, the CIT(A) sustained the working of the AO under rule 8D of the Rules.

On appeal, it was held that the AO cannot simply brush aside the claim made by the assessee, but he must first give cogent reasons for not being satisfied with the correctness of the claim of the assessee, in respect of such expenditure. The road leading to application of rule 8D of the Rules goes through section 14A(2) of the Act, because, unless the AO gives a reasoned finding that the expenditure shown or even not shown in the assessee's account is incorrect, he cannot proceed to compute the disallowance as prescribed. There was no reasoned finding against the disallowance computed and shown by the assessee and the AO had computed the disallowance by applying rule 8D mechanically, without meeting the claim of the assessee in support of its computation.

The relevant observations of the Hon.Tribunal are to be found on page 258 of the Report and the same are reproduced as follows :

"*We have heard the arguments and perused the material on record. In the present case, the assessee had made a disallowance, which the Assessing Officer, did not consider to be incorrect. The Legislature has use the words, "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 such expenditure". This only means that the Assessing Officer cannot simply brush aside the claim made by the assessee, but first the Assessing Officer must give cogent reasons for his not being satisfied with the correctness of the claim of the assessee in respect of such expenditure.*

In our considered opinion, the road leading to application of rule 8D of the Income-Tax Rules, goes through section 14A(2) of the Income-Tax Act, 1961. This is so because, unless the Assessing Officer gives a reasoned finding that the expenditure shown or even

not shown in its / his books are incorrect, he cannot proceed to compute the disallowance, as prescribed.

In the present set of circumstances, we find that there is no reasoned finding against the disallowance computed and shown by the assessee and the Assessing Officer has computed the disallowance applying rule 8D mechanically, without meeting the claim of the assessee in support of its computation.

In these circumstances, we set aside the order of the Commissioner of Income-Tax (Appeals) on this issue and direct the Assessing Officer to compute the disallowance, by giving a reasoned finding for not accepting the disallowance made by the assessee suo motu. The disallowance to be computed by the Assessing Officer shall be as per law, needless to observe, after affording reasonable opportunity to the assessee to present its case."

In view of the aforesaid reasons, the aforesaid matter was set aside to the AO, with a direction to compute the disallowance as per law.

In the light of the aforesaid legal precedents, it is clearly established that the AO cannot simply brush aside the claim made by the assessee, in respect of disallowance under section 14A of the Act. The road leading to the application of rule 8D of the Rules goes through section 14A(2) of the Act, because unless the AO gives a reasoned finding that the expenditure shown or even not shown in the assessee's accounts is incorrect, he cannot proceed to compute the disallowance as prescribed.

III. In case assessee's own funds are in excess of the investments yielding exempt income, then it has to be presumed that the investments have come from the interest-free funds available with the assessee.

In connection with the disallowance under section 14A of the Act by the AO, in numerous cases a dispute arises regarding the expenditure incurred by the assessee, by way of interest during the previous year. The AO normally estimates such expenditure on the basis of proportionate interest on borrowed funds, towards earning exempt income and disallows the same under section 14A of the Act. Such an approach on the part of the AO is not correct.

In such a situation, the judgement of the Hon.Bombay High Court, in the case of *CIT Vs Reliance Utilities and Power Ltd [2009] 313 ITR 340 (Bom) : 18 DTR 1 (Bom)* is very relevant.

It was held in this case that if there were funds available both interest-free and overdraft and / or loans taken, then a presumption would arise that the 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.

Based on the aforesaid judgement of the Bombay High Court, the Mumbai Bench of the Tribunal, in the case of *Reliance Industries Ltd Vs Addl.CIT [2012] 79 DTR (Trib) 315 (Mum),* rendered a very significant judgement, relating to disallowance under section 10A of 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.

IV. Quantum of disallowance under section 14A, if at all, any.

We may now look into the issue whether any disallowance, at all, is called for in a particular case and if so, what would be the quantum of disallowance under section 14A. In this regard, a reference may be made to the relevant legal precedents, which are as follows :

1. *CIT Vs Reliance Industries Ltd [2011] 339 ITR 632 (Bom)*

   It was held in this case that as per the Tribunal, the assessee had earned dividend income only from three companies and there was no fact of having incurred any expenditure for the purpose of earning the dividend income. Accordingly, the order of the Tribunal deleting the disallowance under section 14A, was upheld.

2. *CIT Vs Hero Cycles Ltd [2010] 323 ITR 518 (P&H) : [2009] 31 DTR 301 (P&H)*

It was held in this case that disallowance under section 14A requires a finding of incurrence of expenditure. Where it is found that for earning exempted income, no expenditure has been incurred, disallowance under section 14A cannot stand. Consequently, disallowance was not permissible.

3. *CIT Vs Metalman Auto P.Ltd [2011] 336 ITR 434 (P&H)*

It was held in this case that disallowance under section 14A of the Act, requires a finding of incurrence of expenditure for earning the exempted income. In case no expenditure has been incurred, the disallowance under section 14A is not justified. In other words, there cannot be a presumption that certain expenditure is bound to be incurred for earning the exempted income.

4. *Escorts Ltd Vs ACIT [2006] 102 TTJ 522 (Del)*

It was, *inter alia*, held in this case that in order to apply the provision of section 14A, it envisages two steps (i) first the incomes which do not form part of the total income under the Act, have to be identified, and (ii) secondly the expenditure which is related to such income has to be identified.

In the instant case, the dividend income of Rs.8.9 crores and interest income of Rs.10.3 crores are excluded from the purview of total income under the Act, on account of sections 10(33) and 10(23G), respectively.

In this case, no disallowance was held to be permissible in respect of direct expenses, including interest expenses. As regards the management and administration expenses for earning such income, it was held that not much activity is required on earning the dividend or interest income, once the investments have been made.

However, in the absence of separate accounts by which management and administration expenses attributable to earning of dividend and interest income can be segregated, the same were estimated at Rs.2 lakhs on consideration of relevant facts.

If we work out the percentage of the expenditure disallowed, viz. Rs.2 lakhs in respect of the total exempt income of Rs.19.03 crores in the aforesaid case, then the percentage of disallowance works out to 0.1 percent of the total exempt income, approximately.

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

It was held in this case that 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. The burden is on the Assessing Officer to prove nexus between expenditure disallowed and non-taxable receipts, under the provisions of section 14A of the Act.

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

It was, *inter alia*, held in this case 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 pinpoint such expenditure on the basis of material on record. There being no material with the AO to show that no expenditure was incurred in earning dividend income, nothing could be disallowed under section 14A.

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

In this case, the assessee company earned tax-free income, by way of dividend 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 estimated the appeal expenses on earning tax-free income at 0.5% of the 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 on earning dividend cannot be a fixed percentage of dividend income, even in cases where such expenses are incurred.** Expenses, if any, incurred for earning dividend do not vary with the rate of dividend declared by the companies. Therefore, disallowance under section 14A was not sustainable.

8. *ACIT Vs Jindal Saw Pipes Ltd [2008] 118 TTJ 228 (Del) : 11 DTR 281 (Del)*

It was, *inter alia*, held in this case that 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. 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.

The aforesaid legal precedents are very relevant in regard to the disallowance under section 14A(2) of the Act. Therefore, the disallowance, if any, under section 14A(2) of the Act, must be governed by the principles laid down in the aforesaid legal precedents.

Besides, it may also be stated that if adequate disallowance under section 14A(2) can be worked out on the basis of the facts provided by the assessee in respect thereof, then the AO should preferably work out the quantum of disallowance within the parameters of section 14A(2) of the Act, without straight away proceeding to apply rule 8D of the Rules.

In this context, it may be further stated that almost all the AOs are under an erroneous impression that if the AO rejects the claim of the assessee, with regard to the correctness of the amount of disallowance under section 14A(2), then he is entitled to straight away apply rule 8D of the Rules. It may also be stated here that unfortunately almost all the AOs try to reject the claim of the assessee in this regard and thereafter, straight away apply rule 8D of the Rules. Such an approach is very unfair and the same should be avoided in the interest of justice, fair play and good conscience.

It may also be reiterated here that the condition precedent for the AO entering upon a determination of the amount of expenditure incurred in relation to exempt income, is that the AO must give a reasoned finding that the expenditure disallowed or not disallowed by the assessee is incorrect. Without bringing on record such a reasoned finding against the disallowance computed and shown by the assessee, the AO cannot proceed to compute the disallowance, as per rule 8D of the Rules.

It may be further stated here that in case the AO finds a minor difference in the quantum of disallowance made by the assessee, then he should work out the same within the parameters of section 14A(2) of the Act, without straight away proceeding to apply rule 8D of the Rules.

This may be explained by an example. Suppose an assessee has got dividend income which is exempt from tax, to the extent of Rs.2.5 crores. The dividend income is received by the assessee from Mutual Fund schemes, where the relevant transactions are directly entered in the bank account of the assessee by the entity running the Mutual Fund scheme. In such a case,

suppose there are only five transactions undertaken by the assessee during the whole of the relevant financial year, then at the most expenditure in respect of one such transaction may be adopted at Rs.1,000 and thus, the total expenditure relating to the aforesaid transactions will work out only to Rs.5,000. Besides, even if we adopt the disallowance at the rate of 0.1% of the total exempt income, then the disallowance will work out to Rs.25,000. However, if the disallowance is computed as per rule 8D, it may work out to a figure of more than 25 lakhs. It may, thus, be seen that the aforesaid erroneous approach on the part of the AO, regarding the disallowance under section 14A of the Act, may cause lot of harassment and inconvenience to the assessee.

It is for the aforesaid reasons that the AOs should be very circumspect in regard to the disallowance under section 14A of the Act.

V. Conclusion

In the light of the discussion in the preceding paras (I), (II), (III) and (IV), it may be concluded that –

1. In view of the purpose of insertion and interpretation of section 14A, as per the CBDT and the Supreme Court, the AO cannot straight away proceed to apply rule 8D, without considering the correctness of the claim made by the assessee, in respect of expenditure incurred in relation to exempt income.

2. Besides, in the light of the relevant legal precedents also, it is clearly established that the AO cannot simply brush aside the claim made by the assessee, in respect of disallowance under section 14A of the Act. The road leading to the application of rule 8D of the Rules goes through section 14A(2) of the Act, because unless the AO gives a reasoned finding that the expenditure shown or even not shown in the assessee's accounts is incorrect, he cannot proceed to compute the disallowance as prescribed.

3. In other words, the AO cannot proceed to apply rule 8D in each and every case, without first complying with the provisions of section 14A(2) of the Act.

   It is only in those cases where the AO is not satisfied with the correctness of the claim of the assessee, in respect of the expenditure disallowed as per section 14A(2) of the Act, that he is entitled to compute such disallowance, as per rule 8D of the Rules.

4. Besides, it may also be stated that in case the AO finds minor difference in the quantum of disallowance made by the assessee, as compared to the adequate disallowance as per the AO, then the AO should preferably work out the quantum of disallowance within the parameters of section 14A(2) of the Act, without straight away proceeding to apply rule 8D of the Rules.

   This approach will be just and fair and also in accordance with the spirit of the provisions of section 14A of the Act.

5. Besides, for rejecting the correctness of the claim of the assessee, the AO will be required to give a reasoned finding that the expenditure or no expenditure disallowed by the assessee is incorrect.

6. Only expenditure factually incurred on non-taxable income may be disallowed. In other words, there cannot be a presumption that certain expenditure is bound to be incurred for earning the exempt income.

7. The burden lies on the AO to prove the nexus between the expenditure disallowed and non-taxable income, under the provisions of section 14A of the Act.

8. The expenses on earning dividend income cannot be a fixed percentage of dividend income, because the expenses, if any, incurred for earning dividend income, do not vary with the quantum of receipt of dividend declared by the companies.

9. In view of the aforesaid reasons, the AO should be very circumspect in regard to the disallowance under section 14A of the Act, because the prevalent approach of the AOs in this regard is very unfair and the same should be avoided in the interest of justice, fair play and good conscience.

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