

**Disallowance under section 14A, in the light of landmark judgement of Punjab and Haryana High Court, in the case of Deepak Mittal**

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By S.K.Tyagi

Recently, the Punjab and Haryana High Court has rendered a very significant judgement, regarding disallowance under section 14A of the Income-Tax Act, 1961 (the Act), r.w.r.8D of the Income-Tax Rules 1962 (the Rules), in the case of *CIT Vs Deepak Mittal [2014] 361 ITR 131 (P&H) : [2013] 219 Taxman 314 (P&H)*. This judgement is really a landmark judgement, in regard to the disallowance under section 14A of the Act, relating to the expenditure incurred by the assessee for earning exempt income. In this case, the Hon. High Court has laid down that when consistent case / version of the assessee was that he had not incurred any expenditure for earning exempt income, the Assessing Officer (AO), in terms of section 14A(2) of the Act, was to proceed further to collect the relevant material or evidence, to determine the expenditure relating to such exempt income. It was also held that application of rule 8D by the AO as a substitute for section 14A(2), is not permissible in law.

In the aforesaid judgement, the Hon. High Court has also referred to its earlier judgement, in the case of *Hero Cycles Ltd [2010] 323 ITR 518 (P&H)* and reiterated the view that the contention of the Revenue that directly or indirectly some expenditure is always incurred in earning exempt income and the expenditure so incurred cannot be allowed to be set-off against the business income; cannot be accepted.

In this context, it will also be relevant to refer to my earlier Article under the title “*Disallowance under section 14A – The Assessing Officer cannot straight away apply rule 8D without consideration of claim of assessee under section 14A(2) of the Act*”, which was published in 358 ITR (Journ.) 30.

*We may now discuss the aforesaid judgement of Punjab and Haryana High Court in detail.*

In the aforesaid judgement, the Hon. High Court was seized of the issue of disallowance under section 14A of the Act, r.w.r.8D of the Rules for the assessment years (AYs) 2007-08, 2008-09 and 2009-10. As the facts for all the aforesaid AYs were similar, the facts prevailing for the AY 2007-08, were taken up for consideration, for the sake of convenience.

In this case, the issue of disallowance under section 14A of the Act, r.w.r. 8D of the Rules, was before the Hon. High Court, for the AYs 2007-08, 2008-09 and 2009-10. As the facts for all the aforesaid AYs were similar, the facts prevailing in the case of the assessee for the AY 2007-08, were taken up for clarity and convenience.

In this case the assessee had earned dividend income and claimed that no expenses were incurred against earning of such income for the AY 2007-08. The Assessing Officer (AO), disagreeing with the plea of the assessee held that interest bearing funds had been invested for generating dividend income and thus, made an addition of Rs.30,31,212, by way of disallowance under section 14A r.w.r. 8D. The CIT(A) deleted the addition on the ground that the AO was not justified in making the disallowance. In further appeal preferred by the Revenue, the Tribunal dismissed the appeal.

It was on further appeal by the Revenue against the order of the Tribunal before the High Court that the High Court had to be with the aforesaid issue for three assessment years, including AY 2007-08.

The Hon. High Court in para (10) of its order has referred to para (14) of the judgement of the Tribunal by stating that in para (14) of its judgement, the Tribunal has observed as follows :

*“ Before any disallowance is made, essentially there has to be certain expenditure which must have been incurred by the assessee, which in the present case is missing. The Assessing Officer has not brought on record any expense having been incurred by the assessee to earn the non-exempt income or the exempt income. In the absence of the same, it cannot be said that the assessee had actually incurred any expenditure. Therefore, whether before insertion of Rule 8-D or thereafter this fact has to be brought on record by the authorities below which in the present case has not been done.*

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*Having not incurred any expenditure which can be disallowed or any such expenses having not been brought on record, there cannot be any disallowance of any expenditure under Rule 8-D or otherwise against the exempt income. Our view finds support from the decision in the case of Hero Cycles Limited and Walfort Share & Stock Brokers (P) Ltd. (supra). In the circumstances and facts of the case, we find no infirmity in the findings of ld. CIT(A). Thus, ground No.2 of Revenue is dismissed.”*

Upholding the judgement of the Tribunal, it was held by the High Court that when consistent case / version of the assessee, despite notice given by the AO to give details of the expenditure incurred on earning of exempt income in the nature of dividend, was that he had not incurred any expenditure on earning such income, the AO, in terms of section 14A(2) of the Act, was to proceed further to collect such material or evidence to determine expenditure, if any, incurred by the assessee. The AO, however, relying on rule 8D of the Rules applied as a formula applicable to an assessee who had incurred expenditure by way of interest which is not directly attributable to any particular income or receipt. Such was not the case in the case of the present assessee and therefore, there was clearly a wrong application of rule 8D, as a substitute for section 14A(2) of the Act which is not permissible in law.

The Hon. High Court also referred to its earlier judgement in the case of *Hero Cycles Ltd. [2010] 323 ITR 518 (P&H)* and reiterated the view that the contention of the Revenue that directly or indirectly some expenditure is always incurred which must be disallowed under section 14A and the impact of expenditure so incurred can not be allowed to be set-off against the business income which may nullify the mandate of section 14A; cannot be accepted. The disallowance under section 14A requires a finding of incurrence of expenditure and where it is found that for earning exempt income, no expenditure has been incurred, disallowance under section 14A can not stand.

The aforesaid judgement of the High Court fully supports the view expressed by me, regarding disallowance under section 14A of the Act, in my Article under the title “*Disallowance under section 14A - The Assessing Officer can not straightaway apply rule 8D, without consideration of claim of assessee under section 14A(2) of the Act*”, published in 358 ITR (Jour)30.

For the sake of ready reference, the conclusion of the aforesaid Article in para V thereof, on page 47 of the Report, is reproduced as follows :

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#### **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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As per the aforesaid para V(4), 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 straightaway proceeding to apply rule 8D of the Rules. I am happy to state here that the aforesaid view expressed by me has now been fully supported by the aforesaid judgement of Punjab and Haryana High Court in the case of *Deepak Mittal (Supra)*.

The aforesaid Article as well as the aforesaid judgement of Punjab and Haryana High Court lay down the parameters in respect of the disallowance to be made under section 14A(2), if any. The AOs must follow the aforesaid method for disallowance under section 14A(2), because the straightaway application of rule 8D leads, in many cases, to ludicrous results. I may cite here a number of instances where the disallowances worked out by the AO, as per rule 8D, in respect of the expenditure relating to exempt incomes were much higher than the exempt incomes themselves. Recently, in a case of one of my clients, the AO made a disallowance of Rs. 75 lakhs approx. in respect of exempt dividend income of Rs.9 lakhs. Here, it must be understood that section 14A(2) and rule 8D were framed in order to make adequate disallowance under section 14A(2), *vis-à-vis* the quantum of the exempt income. The way the AOs are presently rushing to apply rule 8D for disallowance under section 14A without even pausing for a moment to weigh the impact of the provisions of section 14A(2) of the Act, has made a total mockery of the very purpose of bringing section 14A on the statute.

### **Conclusion**

In the light of the discussion in the preceding paragraphs, the aforesaid judgement of the Punjab and Haryana High Court has laid down a very fair and reasonable method for the AO to follow in respect of disallowance under section 14A(2), r.w.r. 8D.

The gist of the aforesaid judgement is that in case the AO does not agree with the quantum of disallowance made by the assessee under section 14A(2), he should not straightaway proceed to

apply rule 8D, but instead, he must collect the relevant material or evidence to determine the expenditure, if any, incurred by the assessee in relation to the exempt income.

It is, therefore, advised that the AOs, in view of the principles of equity and fair play and the very intention behind the insertion of section 14A in the Act, must follow the method for disallowance under section 14A of the Act, as laid down by the Punjab and Haryana High Court, in the case of *CIT Vs Deepak Mittal [2014] 361 ITR 131 (P&H) : [2013] 219 Taxman 314 (P&H)*.

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<b>S. K. TYAGI</b>	<b>Office</b>	: (020) 26133012	Flat No.2, (First Floor)
M.Sc., LL.B., <b>Advocate</b>		: (020) 40024949	Gurudatta Avenue
Ex-Indian Revenue Service	<b>Residence</b>	: (020) 40044332	Popular Heights Road
<b>Income-Tax Advisor</b>	<b>E-mails</b>	: sktyagidt@airtelmail.in	Koregaon Park
<b>Website:</b> www.sktyagidt.com		: tyagi@sktyagidt.com	PUNE - 411 001

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