No disallowance under section 14A, where the assessee has got no income from a composite and indivisible business

[Published in 384 ITR (Jour) 1 (Part-1)]

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Recently in the case of one of my clients, the Assessing Officer (AO), during the course of assessment proceedings for the AY 2013-14, raised a query about the disallowance of expenditure under section 14A of the Income-Tax Act, 1961 (the Act), in respect of income from dividends, to the extent of Rs.46,859, which is exempt from tax under section 10(34) of the Act.

In the present context, it would be necessary to state that the total income of the aforesaid client for the AY 2013-14, consisted of the following items of income, other than the aforesaid dividend income of Rs.46,859.

(i) Income from house property…….Rs.8,86,824
(ii) Capital gains (Sale of shares of listed companies)……Rs.3,36,290
(iii) Income from other sources (Interest from FDs with bank)……..Rs.1,54,218
Total income……Rs.13,77,332

It may, thus, be seen that the assessee in the present case, has got no income from business or profession.

In response to the aforesaid query, a letter was addressed to the AO, wherein the following stand was taken :

(i) No disallowance under section 14A of the Act is contemplated in a case where the assessee has got no income from a composite and indivisible business which earns both taxable and non-taxable income.
(ii) No disallowance is permissible in a case where no expenditure has been incurred for earning the exempt income, particularly in a case where the exempt income, by way of dividend was directly credited to the bank account of the assessee.

A letter containing detailed submissions in respect of the aforesaid stand of the assessee was addressed to the AO. Thereafter, the AO, while passing the aforesaid assessment order under section 143(3) of the Act for the AY 2013-14, has made no disallowance under section 14A of the Act. Thus, the aforesaid stand of the assessee was accepted by the AO.

However, I am aware of a number of cases where the Assessing Officers are making disallowance under section 14A of the Act, even in cases where the assessee has got no income from business. Such disallowances are being made by the Assessing Officers without application of mind to the provisions of section 14A of the Act.

In the light of the aforesaid reasons, I decided to prepare an Article on the basis of the aforesaid submissions, which were furnished before the AO in the case of the aforesaid client.

The scope of this Article is to cover only two aspects which are as follows :

(a) No disallowance under section 14A is contemplated in a case where the assessee has got no income from a composite and indivisible business, which earns both taxable and non-taxable income.

(b) No disallowance is permissible in a case where no expenditure has been incurred for earning the exempt income, particularly in a case where the exempt income, by way of dividend, etc, is directly credited to the bank account of the assessee.

Both the aforesaid aspects are discussed in detail, as follows :

I. No disallowance under section 14A is contemplated in a case where the assessee has got no income from a composite and indivisible business, which earns both taxable and non-taxable income.

In regard to the stand that no disallowance under section 14A is contemplated in a case where the assessee has got no income from a composite and indivisible business, which earns both taxable and non-taxable income, the purpose of the insertion of section 14A by the Finance Act, 2001, with retrospective effect from 1.4.1962, will have to be examined.

At the outset, it may be emphatically stated that disallowance under section 14A is contemplated only in case of composite and indivisible business, which earns both taxable and non-taxable income. This proposition / stand is supported by the following judgements :

(i) Godrej and Boyce Mfg.Co.Ltd Vs. Dy.CIT [2010] 328 ITR 81 (Bom)
(ii) CIT Vs Walfort Share and Stock Brokers P.Ltd [2010] 326 ITR 1 (SC)
(iii) Wimco Seedlings Ltd Vs Dy.CIT [2007] 293 ITR (AT) 216 (Del)

The relevant parts of the aforesaid judgements are discussed as follows :

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

The Bombay High Court, in the aforesaid judgement has discussed in detail the provisions of section 14A of the Act.

The relevant observations of the High Court are discussed as follows :

A. Observations on page 95 of the Report, paragraph 22

On page 95 of the Report, the relevant observations, vide paragraph 22 of the judgement are as follows :

The principle of law which emerged from these cases was that in the case of a ***composite and indivisible business*** *which earned both taxable and non-taxable income, expenditure incurred towards non-taxable income could not be isolated by apportionment and a disallowance could not be made. However, apportionment of expenditure was permissible when the non-taxable income arose from a separate business or under a different head of income".* [Emphasis added]

B. Observations on page 96 of the Report, paragraph 25

Vide the aforesaid paragraph 25, on page 96 of the Report, the High Court has discussed the purpose of the insertion of section 14A by the Finance Act, 2001. The aforesaid observations, vide paragraph 25, on page 96 of the Report are as follows :

"*Prior to the insertion of section 14A, the Revenue had sought to disallow the expenditure incurred in relation to exempt income. However, the Supreme Court in Maharashtra Sugar [1971] 82 ITR 452 and in Rajasthan State Warehousing Corporation Vs CIT [2000] 242 ITR 450 (SC) held that where there is one indivisible business giving rise to taxable income as well as exempt income, the entire expenditure incurred in relation to that business would have to be allowed even if a part of the income earned from the business is exempt from tax.* ***Section 14A has been enacted to overcome these judicial pronouncements."*** [Emphasis added]

C. Summation of the conclusions of the High Court on page 108 vide paragraph 55 of the Report

Vide paragraph 55 on page 108, the High Court has given a summation of its conclusions on the interpretation of the provision of section 14A of the Act. In the present context, clauses (i) and (iii) of the aforesaid summation are relevant and the same are reproduced as follows :

Clause (i)

(i) Section 14A was enacted by Parliament in order to overcome the judgements of the Supreme Court in the case of Indian Bank [1965] 56 ITR 77, Maharashtra Sugar [1971] 82 ITR 452 and Rajasthan State Warehousing Corporation [2000] 242 ITR 450 in which it was held that in the case of a ***composite and indivisible business****, which results in earning of taxable and non-taxable income, it is impermissible to apportion the expenditure between that which was laid out for the earning of taxable as opposed to non-taxable income;* [Emphasis added]

Clause (iii)

(iii) From this it would follow that section 14A has implicit within it a notion of apportionment. The principle of apportionment which prior to the amendment of section 14A would not have applied to ***expenditure incurred in a composite and indivisible business which results in taxable and non-taxable income, must after the enactment of the provisions apply even to such a situation.*** [Emphasis added]

From the aforesaid observations of the High Court, it is clearly established that section 14A of the Act was enacted to overcome the judicial pronouncements by the Supreme Court, in the case of *CIT Vs Maharashtra Sugar Mills Ltd [1971] 82 ITR 452 (SC)* and *Rajasthan State Warehousing Corporation Vs CIT [2000] 242 ITR 450 (SC).* The reason for the same was that in the aforesaid judgements, the Supreme Court held that where there is one indivisible business, giving rise to taxable as well as exempt income, the entire expenditure incurred in relation to that business would have to be allowed even if a part of the income earned from the business is exempt from tax.

Further, in this connection the Bombay High Court, on page 95 of the Report, has clearly stated that the principle of law which emerged from the aforesaid cases was that in case of a composite and indivisible business which earns both taxable and non-taxable income, expenditure incurred towards non-taxable income could not be isolated by apportionment and a disallowance could not be made. However, apportionment of expenditure was permissible when the non-taxable income arose from a separate business or under a different head of income. Besides, vide clause (iii) of the summation of page 108 of the Report, it has been held that section 14A has implicit within it a notion of apportionment. The principle of apportionment, which prior to the amendment would not have applied to expenditure incurred in a composite and indivisible business, which results in a taxable and non-taxable income, must after the enactment of the provisions apply even to such a situation.

It is, thus, clearly established that the provisions of section 14A will apply only in a case of a composite and indivisible business, which results in both taxable and non-taxable income. As a corollary, it implies that the provisions of section 14A will not apply in a case where an assessee has got income from various other heads listed under section 14 of the Act, except the income from business / profession.

In the present context, clause (iv) of paragraph 55 of the summation of the conclusions of the High Court, on page 108 of the judgement, is also relevant. The same is reproduced as follows :

"*(iv) The expression "expenditure incurred" in section 14A refers to expenditure on rent, taxes, salaries, interest, etc, in respect of which allowances are provided for*".

In this regard, a reference may also be made 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).* On page 17 of the aforesaid judgement, the Supreme Court has observed as follows :

"*Reading section 14 in juxtaposition with sections 15 to 59, it is clear that the words "expenditure incurred" in section 14A refers to expenditure on rent, taxes, salaries, interest, etc, in respect of which allowances are provided for (see sections 30 to 37)*".

It is, thus, clearly established that the expression "*expenditure incurred*" referred to in section 14A is the expenditure allowable under the provisions of sections 30 to 37 of the Act, which fall under Chapter IV-D of the Act, relating to computation of business income.

The aforesaid observations of the Supreme Court, in the case of *Walfort Share and Stock Brokers P.Ltd,* further strengthens the stand that section 14A applies only in case of composite and indivisible business, which results in taxable and non-taxable income.

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

In the present context, it may be stated that the Supreme Court, in the case of *CIT Vs Walfort Share and Stock Brokers P.Ltd [2010] 326 ITR 1 (SC), w*as, *inter alia*, seized with the interpretation of the provisions of section 14A of the Act.

For our purpose, the observations of the Supreme Court, on page 17 of the Report are relevant. The same are reproduced as follows :

"The theory of apportionment of expenditure between taxable and non-taxable has, in principle, been now widened under section 14A. ***Reading section 14 in juxtaposition with sections 15 to 59, it is clear that the words "expenditure incurred" in section 14A refers to expenditure on rent, taxes, salaries, interest, etc. in respect of which allowances are provided for (see sections 30 to 37).*** *Every pay-out is not entitled to allowances for deduction. These allowances are admissible to qualified deductions. These deductions are for debits in the real sense. A pay-back does not constitute an "expenditure incurred" in terms of section 14A. Even applying the principles of accountancy, a pay-back in the strict sense does not constitute an "expenditure" as it does not impact the profit and loss account. Pay-back or return of investmentt will impact the balance sheet whereas a return on investment will impact the profit and loss account. The cost of acquisition of an asset impacts the balance sheet. Return of investment brings down the cost. It will not increase the expenditure. Hence, expenditure, return on investment, return of investment and cost of acquisition are distinct concepts.* ***Therefore, one needs to read the words "expenditure incurred" in section 14A in the context of the scheme of the Act and, if so read, it is clear that it disallows certain expenditure incurred to earn exempt income from being deducted from other income which is includible in the "total income" for the purpose of chargeability to tax. As stated above, the scheme of sections 30 to 37 is that profits and gains must be computed subject to certain allowances for deductions/expenditure.*** *The charge is not on gross receipts, it is on profits and gains. Profits have to be computed after deducting losses and expenses incurred for business. A deduction for expenditure or loss which is not within the prohibition must be allowed if it is on the facts of the case a proper debit item to be charged against the incomings of the business in ascertaining the true profits. A return of investment or a pay-back is not such a debit item as explained above, hence, it is not "expenditure incurred" in terms of section 14A. Expenditure is a pay-out. It relates to disbursement. A pay-back is not an expenditure in the scheme of section 14A.* ***For attracting section 14A, there has to be a proximate cause for disallowance, which is its relationship with the tax exempt income.*** *Pay-back or return of investment is not such proximate cause, hence, section 14A is not applicable in the present case. Thus, in the absence of such proximate cause for disallowance, section 14A cannot be invoked."* [Emphasis added]

From the aforesaid observation of the Supreme Court, it may be clearly seen that on reading section 14 in juxtaposition with sections 15 to 59, which quantify the total income chargeable to tax, it is clear that the expression "*expenditure incurred*" in section 14A refers to the expenditure on rent, taxes, salaries, interest, etc, in respect of which allowances are provided under sections 30 to 37 of the Act.

Thus, the aforesaid stand that section 14A applies only in a case of a composite and indivisible business, which results in earning of taxable and non-taxable income, gets further fortified.

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

The aforesaid stand that section 14A applies only in a case of composite and indivisible business, which earns both taxable and non-taxable income, is further supported by the judgement of Delhi Bench of the Tribunal, in the case of *Wimco Seedlings Ltd Vs Dy.CIT [2007] 293 ITR (AT) 216 (Del)***.** This is a Third Member judgement. In the present context, the observations of the Third Member, vide paragraph 64, on pages 244 and 245 of the Report, are relevant. The same are reproduced as follows :

"In my view, the order of the learned Judicial Member is to be preferred. On the construction of section 14A, I am inclined to agree with the learned Judicial Member that only expenditure which has been proved to have been incurred in relation to the earning of tax free income can be disallowed and the section cannot be extended to disallow even expenditure which is assumed to have been incurred for the purpose of earning the tax free income. The word "incurred" refers to the factual spending of the expenditure in relation to the exempt income and does not refer to a deemed spending or assumed spending for the purpose. The learned Accountant Member has referred to the memorandum explaining the Finance Bill, 2001. ***His conclusion is that the section has been introduced to nullify certain decisions of the Supreme Court (cited supra). The proposition laid down in those decisions is 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, then the expenditure incurred by the assessee for the purposes of the indivisible business cannot be artificially broken up to identify and disallow expenditure which is supposed to have been incurred for the purpose of earning the exempted income. It was this proposition that is sought to be nullified by section 14A as rightly held by the learned Accountant Member.*** *However, while applying the section there is no authority conferred by the section upon the AO 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 relationship 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 would seem to be on the AO to not only show that some expenditure was factually incurred but also to show its***

relationship with the income exempt from tax. The section may have nullified the judgments of the Supreme Court cited above but only to the extent that even in an indivisible business consisting partly of taxable activities and partly of tax-free activities it is open to the AO to identify expenditure, if any, incurred in relation to the earning of non-taxable income and disallow the same*. But the section cannot be taken beyond that and every item of expenditure which has no apparent connection or nexus with the earning of the tax free income cannot in part be attributed on some yardstick, whatever may be the sanctity behind such yardstick, to the earning of the tax free income."* [Emphasis added]

From the aforesaid observations, it may be seen that Third Member has approved the observations of the Judicial Member, that section 14A was inserted in the Act, to nullify certain decisions of the Supreme Court, wherein it was held that where the business activities constitute an indivisible business giving rise to both taxable as well as non-taxable income, then the expenditure incurred by the assessee for the purposes of indivisible business could not be artificially broken up to identify and disallow the expenditure incurred for the purpose of earning the exempted income.

Further, the Third Member has observed that section 14A may have nullified the judgements of the Supreme Court, cited Supra, but only to the extent that even in an indivisible business consisting partly of the taxable activities and partly of tax-free activities, it is open to the AO to identify the expenditure, if any, incurred in relation to the earning of non-taxable income and disallow the same.

Thus, the aforesaid Third Member judgement also supports the stand that section 14A applies only in the case of a composite and indivisible business, which earns both taxable and non-taxable income.

From the aforesaid judgement, it is clearly established that section 14A applies only in the case of a composite and indivisible business which earns both taxable and non-taxable income. It, therefore, implies that section 14A will not apply in a case where the assessee has got income under other heads of income, except income from business.

It may also be stated here that as per the aforesaid judgement of the Supreme Court, in the case of *Walfort Share and Stock Brokers P.Ltd,* the expression "*expenditure incurred*" in section 14A refers to the expenditure on rent, taxes, salaries, interest, etc, the deduction in respect of which is provided under sections 30 to 37 of the Act.

II. No disallowance is permissible in a case where no expenditure has been incurred for earning the exempt income, particularly in a case where the exempt income, by way of dividend is directly credited to the bank account of the assessee.

As already stated, the scope of the present Article also covers the stand that the word "*incurred*" in section 14A of the Act, refers to the factual spending of the expenditure, in relation to the exempt income and in case no expenditure has been incurred by the assessee for earning exempt income, no disallowance under section 14A of the Act is permissible.

A number of judgements delivered by the various High Courts, as well as the Tribunal, support the aforesaid stand. The aforesaid judgements are discussed as follows :

1. *Canara Bank Vs ACIT [2014] 99 DTR 36 (Karn)*

The judgement of Karnataka High Court, in the case of *Canara Bank Vs ACIT [2014] 99 DTR 36 (Karn),* is a landmark judgement, as regards the disallowance contemplated under section 14A of the Act.

It was clearly held in this case that where the assessee has not incurred any expenditure for realizing the exempt income, the question of disallowance under section 14A of the Act, does not arise.

In this case, income was derived by way of dividends exempt under section 10(33), interest on tax-free bonds exempt under section 10(15)(h) and interest on long-term finance to infrastructure companies exempt under section 10(23G) of the Act. The persons with whom the aforesaid investment was made by the assessee were crediting the aforesaid income to the assessee's account by way of a bank transfer.

It was held by the Hon. High Court that there was no human agency involved in collecting these dividends and interest for which the assessee had to incur any expenditure. This is the consequence of computerization, online transaction through NEFT, RTGS and also demat accounts. The AO should take note of these developments in deciding, whether any expenditure is incurred in earning the said income. The discussion by the AO clearly demonstrated that these aspects had not been considered and notional expenditure was calculated on the basis of pre-modernization scenario. **Therefore, when the assessee had not incurred any expenditure for realizing the income, the disallowance of two per cent of gross total income, as an expenditure under section 14A, was not sustainable in law.**

In the present context, paragraph (12) of the judgement on page 48 of the Report is relevant, which is reproduced as follows :

*"**12.** In the instant case, facts set out above demonstrate the income is derived by the dividends under section 10(33) of the Act and interest on tax free bonds under section 10(15)(h) of the Act and interest on long-term finance to infrastructure companies under section 10(23G) of the Act, In other words, the persons with whom the amounts are invested by the assessee are crediting the aforesaid amount to the assessee's account by way of a bank transfer. Therefore, no human agency is involved in collecting these dividends and interest for which the assessee has to incur any expenditure. This is the consequence of computerization, online transaction through NEFT (National Electronic Fund Transfer). RTGS (Real Time Gross Settlement) and also demat accounts. The assessing authority should take note of these developments in deciding whether any expenditure is incurred in earning the said income. The discussion by the assessing authority clearly demonstrates these aspects have not been taken note of and the notional expenditure is calculated pre-modernization.* ***Therefore, in the light of the aforesaid judgement, when the assessee has not incurred any expenditure for realizing this income, the question of holding that 2 per cent of the gross total income is an expenditure and that has to be added back to the income is unsustainable in law.*** *Accordingly, the substantial question of law is answered in favour of the assessee and against the Revenue."* [Emphasis added]

It may be stated here that in most of the cases where exempt income forms part of total income, such exempt income is of the nature of dividend, tax-free interest, etc. Therefore, as laid down by the Karnataka High Court, the aforesaid income will be credited to the account of the assessee by bank transfer, for which no human agency will be involved.

It is, therefore, clearly established that in view of the aforesaid judgement of Karnataka High Court, no disallowance under section 14A of the Act will be permissible if the exempt income is of the nature of dividend and tax-free interest, etc., which is directly credited to the bank account of the assessee.

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

It was held in this case that where no expenditure has in fact been incurred in earning dividend income, no disallowance under section 14A of the Act is permissible.

It was further held in this case that as per 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.

In the present context, the observations of the Tribunal, reproduced on page 634 of the Report, are also relevant. The same are reproduced as follows :

"2. *So far as question (A) is concerned, the CIT(A) held that certain administrative expenses are required to be incurred to keep track of receipt and accruals of dividend income and accordingly, it is not possible to accept that no expenditure has been incurred out of the dividend income. Accordingly, he held that the expenses of Rs. 20 lakhs is sufficient to meet the expenses. The Tribunal in appeal observed that : "The assessee has earned dividend income only from three companies. There is no fact of having incurred any expenditure for the purpose of earning the dividend income. The disallowance, in our view, is misconceived and the same is deleted in the light of the same order". In our opinion, this is purely a finding of fact and, therefore, question (A) as framed would not arise."*

From the aforesaid observations of the High Court, it is clear that the conclusion of the CIT(A) that certain administrative expenses are required to be incurred to keep track of receipt and accruals of dividend income and accordingly, it is not possible to accept that no expenditure has been incurred in respect of dividend income, is totally misconceived.

Therefore, the stand taken by the IT Department in number of cases that some expenditure is always required to be incurred in earning exempt income, is totally erroneous.

3. *CIT Vs Hero Cycles Ltd [2010] 323 ITR 518 (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, no disallowance was permissible.

In the present context, the observations of the High Court, on page 521of the Report are also very relevant, which are reproduced as follows :

"*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 cannot be allowed to be set off against the business income which may nullify the mandate of section 14A, cannot be accepted. Disallowance under section 14A requires finding of incurring of*

expenditure; where it is found that for earning exempted income no expenditure has been incurred, disallowance under section 14A cannot stand. In the present case finding on this aspect, against the Revenue, is not shown to be perverse. Consequently, disallowance is not permissible."

From the aforesaid observations, it is clearly established that 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.

Thus, even in this judgement, the stand of the IT Department that some expenditure is always incurred in earning the exempt income which must be disallowed under section 14A, is held to be totally erroneous.

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

It was held in this case that the disallowance under section 14A of the Act, required a finding of incurrence of expenditure for earning the exempt 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 exempt income.

In the present context, it is also relevant to refer to paragraphs 25 and 26 of the appellate order of the Tribunal, which have been reproduced by the High Court, on pages 442and 443 of the Report. For our purpose, paragraph 26 of the order of the Tribunal, reproduced on page 443 of the Report is relevant, which is reproduced as follows :

"***26***. *Obviously, the issue is to be decided in the light of the judgment of the Hon'ble jurisdictional High Court in the case of Hero Cycles Ltd. (supra). As per the Hon'ble jurisdictional High Court, the disallowance under section 14A requires a finding of incurrence of expenditure for earning the exempt 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 exempt income. Considered in this light, we find that there is no mistake in the order of the Commissioner of Income-Tax (Appeals). Quite clearly, the Assessing Officer had only made a presumption that certain expenditures have been incurred for earning the impugned exempt incomes. Therefore, following the parity of reasoning laid down by the Hon'ble jurisdictional High Court in the case of Hero Cycles Ltd. (supra), we affirm the*

decision of the Commissioner of Income-Tax (Appeals) and accordingly, ground raised by the Revenue is dismissed."

The High Court has approved the conclusion of the Tribunal in the aforesaid paragraph 26, reproduced on page 443 of the Report.

It is, thus, clearly held by the High Court that disallowance under section 14A requires a finding of incurrence of expenditure for earning the exempt income. In case no expenditure has been incurred, the disallowance under section 14A of the Act, is not justified. In other words, there cannot be a presumption that certain expenditure is bound to be incurred for earning the exempt income.

From the aforesaid judgement of the High Court also, it is clear that there cannot be a presumption that certain expenditure is bound to be incurred for earning the exempt income. Therefore, such a stand which is normally adopted by the Revenue, is totally erroneous.

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

This is a Third Member judgement. 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. It was also held in this case that burden is on the AO to prove nexus between the expenditure disallowed and non-taxable receipts under the provisions of section 14A of the Act.

In the present context, the observations of the Third Member, on pages 244 and 245 of the Report are relevant. The aforesaid observations have already been reproduced in the aforesaid paragraph I(3).

From the aforesaid observations of the Third Member, it is clearly established that while applying section 14A, there is no authority conferred upon the AO to deem or assume certain expenditure to have been incurred in relation to the tax-free income.

Besides, it is also clear from the aforesaid observations that the burden on the AO is not only to show that some expenditure was factually incurred, but also to show its relationship with the income which is exempt from tax.

From the aforesaid discussion, it is clearly established that –

(i) When the assessee has not incurred any expenditure for realizing the exempt income, any disallowance of expenditure under section 14A is not sustainable in law.

(ii) 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 is not permissible.

(iii) The burden is on the AO to prove nexus between the expenditure disallowed and non-taxable receipts under the provisions of section 14A of the Act.

(iv) Where the exempt income is directly credited to the bank account of the assessee, in such a case, no human agency is involved in collecting the exempt income. Therefore, no disallowance under section 14A of the Act is called for, in such cases.

III. Conclusion

From the discussion in the preceding paragraphs, the following conclusions may be safely derived :

1. Regarding the applicability of section 14A

In view of the discussion in the preceding paragraph (I), it may be concluded that –

(i) No disallowance under section 14A is contemplated in a case where the assessee has got no income from a composite and indivisible business, which earns both taxable and non-taxable income.

(ii) The expression "*expenditure incurred*" in section 14A refers to expenditure on rent, taxes, salaries, interest, etc, in respect of which allowances are provided under sections 30 to 37 of the Act.

2. Regarding quantum of disallowance under section 14A of the Act.

In view of the discussion in the preceding paragraph (II), it maybe concluded that –

(i) When the assessee has not incurred any expenditure for realizing the exempt income, any disallowance of expenditure under section 14A is not sustainable in law.

(ii) 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 is not permissible.

(iii) The burden is on the AO to prove nexus between the expenditure disallowed and non-taxable receipts under the provisions of section 14A of the Act.

(iv) Where the exempt income is directly credited to the bank account of the assessee, in such a case, no human agency is involved in collecting the exempt income. Therefore, no disallowance under section 14A of the Act is called for, in such cases.

All the tax-payers, CAs and Income-Tax Advisors are, therefore, advised to take into consideration the aforesaid guidelines, relating to the issue of disallowance under section 14A of the Act, particularly in a case where the assessee has got no income from a composite and indivisible business, which earns both taxable and non-taxable income..

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