



**Important aspects of Section 14A -  
of the Income Tax Act, 1961**

**By: CA Sanjay Kumar Agarwal**

❖ **Sec. 14A** –

**Expenditure incurred in Relation to Income Not includible in Total Income...**

**Inserted by Finance Act, 2001, w.r.e.f 1-4-1962**

## **Memorandum explaining the introduction of sec.14A**

*“.....exemptions to certain categories of income are used to reduce also the tax payable on non-exempt income by debiting **expenses incurred to earn the exempt income against taxable income.** This is against the basic principle of taxation whereby only net income is taxed.”*

The intention of the legislature is not to allow the expenses which are incurred to earn the income exempt from tax.

# Provisions of Sec. 14A.....

## Sub-Sec. 1

For 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.

AO shall **determine** the amount of **Expenditure incurred in relation to** exempt income **in accordance with such method as may be prescribed under Rule 8D in following cases.....**

## Sub-Sec. 2

If AO, 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.

## Sub-Sec. 3

where an **assessee claims** that no expenditure has been incurred by him **in relation to** income not forming the part of the total income under this Act.

## **Provided that.....**

❖ Nothing contained in this section shall empower the AO either to reassess u/s 147 or pass an order enhancing the assessment or reducing a refund made or otherwise increasing the liability of the assessee u/s 154, for any A.Y. beginning on or before the 1st day of April, 2001.

*Circular No. 11/2001, dated 23-7-2001, was inserted so as to direct that the assessments where the proceedings have become final before the first day of April, 2001 should not be re-opened under section 147 of the Act to disallow expenditure incurred to earn exempt income by applying the provisions of newly inserted section 14A of the Act. The same view has been expressed in **CIT vs PNB Finance & Industries Ltd [2010]TIOL - 801-HC -DEL -IT.***

## **Analysis of proviso:**

- The proviso to sec14A bars reassessment but not original assessment on the basis of retrospective amendment. ***Honda Siel Power Products Ltd. Vs. Dy. CIT (2011) 197 Taxman415 (Delhi).***
- Bar under **Circular No.11** on reopening of concluded assessment would **not operate where assessment was pending finalization after remand by first appellate authority** in appeal filed by assessee. ***Catholic Syrian Bank Ltd. V. CIT (2010) 187 Taxman 185(Ker.)***
- **where order of CIT under section 263 was passed earlier i.e. on 29/12/1999, the protection under the proviso is to available.** ***Mahesh G. Shetty & Ors. V. CIT (2011) 51 DTR 104 (Kar.)***
- **Whether issue to invoke section 14A be raised before the ITAT for the first time?**  
**Held No: ACIT v. Delite Enterprises (P.) Ltd. (2011)50DTR193 (MUM.) (Trib.)**

# **Rule 8D of Income Tax Rules, 1962.....**

**Method for determining amount of expenditure in relation  
to exempt income**

**Inserted vide notification No. S.O. 547(E) on 24-3-2008**

## **Sub-rule (1) of rule 8D :-**

Where the AO, having regard to the accounts of the assessee of a P.Y., **is not satisfied** with—

- (a) the correctness of the claim of expenditure made by the assessee; or
- (b) the claim made by the assessee that no expenditure has been incurred,

**in relation to income** which does not form part of the total income under the Act for such P. Y., **he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).**



## **Sub-rule (2) of rule 8D:-**

The expenditure shall be the aggregate of following amounts namely:

- i. **Expenditure directly** relating to income (which does not form part of total income)
- ii. In a case where the assessee has incurred expenditure by way of interest during the P.Y., which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely:-  

$$A*(B/C)$$
- iii. an amount equal to 0.5% of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the P.Y.

## Where.....in respect of clause (ii)of sub-rule(2) of R.8D in the formula,

A

= amount of expenditure by way of interest other than amount of interest included in clause (i) incurred during the P.Y.

B

= average of value of investment, income from which does not or shall not form part of the total income, as appearing In the balance sheet, on the first day and the last day of the P. y.

C

= average of total assets as appearing in the balance sheet, on the first day and the last day of the previous year;

## As per sub-rule (3) of Rule 8D:-

*Total assets* shall mean total assets as appearing in the balance sheet [excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.]

## Example on Rule 8D

### Balance sheet as on....

Liab.	31-03-2010	31-03-2011	Assets	31-03-2010	31-03-2011
Eq. sh capital	100	100	Fixed assets	140	100
Loans for inv in bonds & Mutual funds	80	60	Investments shares(L.T)	150	120
General Loans for trading activities	160	140	shares (S.T)	60	45
s. creditors	220	200	Mutual funds (s. 10(23D))	160	160
	210	165	Bonds (other than tax free)	40	40
			stock in trade	220	200
<b>Total</b>	<b>770</b>	<b>665</b>		<b>770</b>	<b>665</b>

During the year ending on 31-03-2011, assessee earned dividend income of Rs. 12 lacs, & int. on mutual funds of Rs. 15 Lacs.

### Interest paid on loans:

For inv. In bonds & M.F (50 Lacs inv in M.F)

Rs. 6 Lacs

For General loans

Rs. 8 Lacs

For trading activities

Rs. 20 Lacs

Calculation of expenses in relation to exempt income:

(i): Exp. directly related to exempt income= int. paid on loan for inv in M.F=  $6 \times \frac{50}{60}$  = Rs. 5 Lacs

(ii) Proportionate exp. of int.= exp by way of int. not directly related to exempt inc. \* (avg value of inv./ avg value of total assets)

$$\text{i.e ( A*B/C)= } 8 * \frac{(150+60+160+120+45+160)/2}{(770+665)/2} = 347.5 \quad = \text{Rs. 3.8745Lacs}$$

(iii)  $\frac{1}{2}\%$  of avg value of inv.  
=  $347.5 * \frac{1}{2}\%$  = Rs. 1.7375 Lacs

Total disallowance= 5 Lacs + 3.8745 Lacs + 1.7375 Lacs  
= Rs. 10.612 Lacs



**Analysis of Provisions &**  
**Issues on Section 14A rw**  
**Rule 8D**

## ***Analysis of the provisions***

➤ **Nexus** between the **expenditure incurred and exempt income**- whether **direct and indirect**.

[ i.e the expenditure should be incurred **in relation to exempt income** ]

➤ Satisfaction of the AO- important aspect.

Expenditures disallowed in view of s.14A are disclosed in clause 17(L) of Form 3CD  
(Tax audit report)

# Constitutional validity of provisions of sec.14A

Godrej & Boyce Mfg. Co. Ltd. v. DCIT [2010] 194 TAXMAN 203/328 ITR 81 (BOM.)

SLP pending with Supreme Court, [No. 36516 of 2010]

Held:

- provisions of sub-sections (2) and (3) of section 14A and Rule 8D are constitutionally valid having a retrospective effect.
- The power of the AO to apply Rule 8D is not automatic and the AO is bound to give an opportunity to the taxpayer to prove the correctness of his claim. It is only where the AO is not satisfied with the claim of the taxpayer he can apply Rule 8D after recording reasons.

The Hon'ble Bom HC has overruled the decision of the Mum. ITAT(SB) in case of ITO v. Daga Capital Management (P.) Ltd. [2009] 117 ITD 169.



## Issues-Expenditure

The term 'expenditure' occurring in section 14A would take in its sweep **not only direct expenditure** but also all forms of expenditure regardless of whether it is fixed, variable, direct, indirect, administrative, managerial or financial.

Kalpataru Construction Overseas (P.) Ltd. v. Dy. CIT [2007] 13 SOT 194 (Mum. - Trib.)

direct & indirect expenses have to be considered as per the rules framed in this regard.

[Case law: Parry Agro Industries v. Asst. CIT 314 ITR (AT) 181(2009) (Cochin)]

Expenditure to be incurred **actually** and not notionally.

The words 'in relation to income which is exempt under the Act', no doubt, appear to be broad at first impression, but on deeper examination, and read in conjunction with the word 'incurred', it seems that these are respective words, restricting the power of the AO to estimate a part of the expenditure incurred by the assessee as relatable to the exempted income. It seems that implicit in the expression 'in relation to' is the concept that the *AO should be in a position to pinpoint, with an acceptable degree of accuracy, the expenditure which was incurred by the assessee to produce non-taxable income.*

Asstt. CIT v. Eicher Ltd. [2006] 101 TTJ (Delhi - Trib.) 369

Wimco Seedlings Ltd. vDy. CIT[2007] 107 ITD 267  
(Del)(TM)

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***Expenditure which has been proved to have be incurred can be disallowed***

As per provisions of section 14A, only expenditure which has been **proved to be incurred in relation to** earning of tax free income can be disallowed and section cannot be extended to disallow even expenditure which is assumed to have been incurred for earning tax free income.

Common expenditure incurred cannot be broken artificially to apportion a part thereof to earning of tax-free income on assumption that such part of common expenditure was incurred in relation to tax-free income.

**DLF Ltd. v. CIT [2009] 27 SOT 22 (DELHI)**

## **Expenditure vs. allowances**

- Section 14A permits a disallowance of “expenditure incurred by the assessee” and not of “allowance admissible” to him.
- The expression “expenditure” does not include allowances such as depreciation allowance. Accordingly, depreciation cannot be the subject matter of disallowance under section 14A.

Similarly, it was further held that the deduction u/s 80D is not expenditure for earning tax-free income but is a permissible deduction from gross total income under Chapter VIA.

Hoshang D. Nanavati vs. ACIT [ITA NO.3567/Mum/07](ITAT Mumbai)(Trib)

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**Whether administrative expenses are disallowable?**

- Administrative expenditure *is disallowable* under section 14A in accordance with rule 8D where the assessee has earned income from dividend and debentures which is exempt under section 10(23G) and Section 10(33)
- **ITO v. Sanatan Textrade Ltd. (2010) 35 DTR (Mum.)**

## ISSUES

Whether there must be a nexus/ relation between the expenditure incurred and income not forming part of total income.

➤ **Held: Yes.**

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

CIT vs. Walfort Share and Stock Private Limited [2010] 326 ITR 1(SC): held, For attracting section 14A, there has to be a proximate cause for disallowance, which is its relationship with tax exempt income and since pay-back or return of investment is not such proximate cause, section 14A is not applicable in such cases.

Space Financial Services v. Asst. CIT [2008] 115 TTJ 165 (Del) addition was deleted holding as under:

“lower authorities were not correct in disallowing proportionate expenditure against the dividend income without establishing the nexus thereto.”

# ISSUES

- Onus is on the revenue to establish the nexus. DCIT vs. Jindal Photo Ltd., [2011-TIOL-25-ITAT-DEL] I.T.A. No. 4539/Del./2010.  
K.J. Arora v. Dy. CIT 180 Taxman 131 (2009) (Delhi) (Mag.)]  
CIT Vs Kasturbhai Mayabhai Pvt. Ltd. (Gujarat)]  
*“In the absence of any specific finding that any particular expenditure was incurred by the assessee in relation to exempted dividend income, no artificial disallowance can be made invoking section 14A of the Act“*  
CIT v. Hindustan Co-op. Society Services Co. Ltd.” [2008] 170 TAXMAN 458 (DELHI), ACIT v. Sun Investments P. Ltd Ltd [2011]008 ITR(Trib)0033 ITAT(del)
- there need be some evidence to establish the nexus: Minda Investments Ltd. vs. DCIT, ITA No. 4046/Del-2009 (ITAT- New Delhi)

# ISSUES

- Sec. 14A can be invoked even if income is received incidentally, Yatish Trading Co. (P.) Ltd. v. ACIT, [9 taxmann.com 164 (2011) (MUM. – ITAT)

If the expenditure is incurred with a view to earn taxable income and there is apparent dominant and immediate connection between the expenditure incurred and taxable income **then as such no disallowance can be made under section 14A merely because some tax exempt income is received incidentally.**



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*Disallowance u/s 14A can be made even in a year in which no exempt income has been earned or received by the assessee.*

Thus proportionate interest pertaining to investment for earning of dividend was disallowable even though exempt income was not earned during the year.

[Cheminvest Ltd. V. ITO 121ITD 318 (2009)  
ITAT(Delhi)(SB)]

*Contrary view by the Hon'ble ITAT- Chennai Bench in Siva Industries & Holdings Ltd. v. ACIT, ITA No. 2148/Mds/2010, date of order 20<sup>th</sup> May, 2011.*

# ISSUES

- Where the interest on borrowings made for investment in shares is capitalised, since in such a case interest paid is not in relation to exempt income, but as part of cost of share, such interest could not be disallowed u/s 14A. [S. Balan V. Dy. CIT 120 ITD 469 (2009) ITAT(Pune)]
- the interest paid on borrowed funds utilized for the purpose of investment in shares was not to be allowed as either an expenditure or as part of cost of acquisition of the shares, in view of the provisions of section 14A. [Mohananlal M. Shah V. DCIT [2008] 3030 ITR(A.T) 221- ITAT-MUM. Harish Krishnakant Bhatt v. ITO [2005] 278 ITR (AT) 1 (Ahmedabad) ; [2004] 85 TTJ 872 ; [2004] 91 ITD 311 followed.]

# **SCOPE OF S. 14A- ISSUES**

*The provisions of section 14A will apply to all income which is exempt whether the income is assessed under the head “Other sources’ or under the head “Business” because there is nothing in Section 14A which restricts the operation of section to income of a particular nature only.*

*Insaallah Investments Ltd. V. ITO (2008) 23 SOT130 (DEL-Trib)*

## **Contd...**

**Where assessee had been able to establish clearly that none of its loan funds were used for purpose of investments** in shares, disallowance under section 14A of notionally attributed interest expense relatable to investments in shares was not justified.

**Voltas Ltd. v. Asst. CIT [2009] 125 TTJ 601 (MUM.)**

**provisions of section 14A have overriding effect over section 36(1)(iii) and section 57.**

**Paharpur Cooling Towers Ltd v. ACIT [2011-TIOL-292-ITAT-KOL]**

• CIT V. D.C.M LTD. 320 ITR 307[DEL] SLP dismissed on 27-11-2009.

• That the Tribunal had found that the assessee in order to ensure that the employees in accordance with the approval granted by the Regional Provident Fund Commissioner, would be paid a rate of interest equivalent to that paid by the Central Government had incurred expenditure. This was an expense incurred by the assessee towards its employees. The loss on sale of securities was only a trigger based on which these expenses had to be incurred by the assessee. Therefore, the provisions of section 14A of the Income-tax Act, 1961 had no application.

G. Venkataswami Naidu and Co. v. CIT [1959] 35 ITR 594 (SC) followed.

## **Investment to earn exempt income out of the borrowed funds.....**

The **fact must be established** that borrowed funds are invested to earn the exempt income and only the expenses to that extent will be disallowed under section 14A.

**CIT vs. Ms. Sushma Kapoor[2009] 319 ITR 299(Del)**

**When there is no evidence that the borrowed amount is utilised for investment in tax free security,** and the major investment was made before the date of borrowings.-  
**section 14A cannot be applied.**

**CIT V. Gujarat Power Corporation Ltd. [2011-TIOL-219-HC-AHM-IT].**

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**M/s Dhanuka & Sons v. CIT [2011-TIOL--248 -HC-KOL-IT]**

It is for the assessee to show the **source of acquisition** of tax free securities those shares by production of materials that those were acquired from the funds available in the hands of the assessee at the relevant point of time without taking benefit of any loan.

In the absence of any such materials placed by the assessee, in, the authorities below rightly held that proportionate amount should be disallowed having regard to the total income and the income from the exempt source.

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**Interest free loans to firm in which assessee was partner**

Assessing officer held that the diversion of borrowed funds by assessee to other firms was not for business purpose and so much so, the interest paid on borrowed capital advanced to other firms was not an allowable deduction under section 36(1)(iii).

It was held that the share income from the partnership firm which is the only consideration for advancing loan to the firm did not constitute income of the assessee under section 10(2A).

Since the share income from the firm did not constitute part of the taxable income of assessee, section 14A applied which prohibited deduction of any expenditure incurred in relation to income not includible in total income.

**CIT v. Popular Vehicles & Services Ltd. [2010] 189 Taxman 14 (Ker)**



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- **Asian PPG Industries Ltd. v. Deputy CIT [2010] 004 ITR(Tri) 017- Mum**
- **Held\_** that the Assessing Officer had disallowed 10 per cent. of the dividend as expenses incurred for earning the dividend under the provisions of section 14A of the Act. While estimating the expenses he had also noticed that the assessee was having loan fund and investment was made for Rs. 150.83 million to earn dividend income. Since disallowance under ground relating to section 14A was not pressed, the addition to that extent was confirmed. No separate disallowance was required under section 36(1)(iii) ) on the same reason that the assessee had invested borrowed funds in investment of Rs. 150.83 million. The addition of Rs. 20,60,000 was to be deleted.

# **Investment out of borrowed funds vis a vis out of owned funds**

**CIT VS. Winsome Textile Industries Ltd.[2009]319 ITR 0204(P&H)**

Disallowance has got to be made u/s 14A if any expenditure relating to the earning of income which is not chargeable to tax has been debited to the accounts by the assessee.

- Since in this case, the assessee has not incurred any expenditure for making investment in the purchase of shares, no disallowance is warranted u/s 14A.

**CIT v. Abhishek Industries Ltd. [2006] 286 ITR 1(P&H)** is not applicable to facts of the case.

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**CIT v. Abhishek Industries Ltd. [2006] 286 ITR 1 (P&H)**

even if the assessee had made investment in shares out of its own funds, the assessee had taken loans on which interest was paid and all the money available with the assessee was in common kitty, as held by this court in and, therefore, disallowance u/s 14A was justified.

Contrary view in **Godrej Industries Ltd. v. DCIT (ITAT Mumbai), ITA No. 1090/Mum/09.**

**Held that s.14A disallowance of interest on borrowings on ground that assessee ought to have borrowings instead of investing in tax free investments, invalid.**

# ISSUES

## *Investments out of Mix funds*

Assessee made investment for earning tax free income from mix funds and it is not possible to ascertain as to whether the investment in tax free was out of assessee's own funds and the Assessing having not established the nexus between the borrowed funds and investment in tax free funds disallowance on pro rata basis was not proper.

*Dy. CIT vs. Maharashtra Seamless Ltd. (2011) 52 DTR 5 (Delhi)(Trib.)*

## **Expenditure incurred in relation to exempt income on account of statutory compliances:**

The expenses, if at all were expenses, they were incurred not for earning tax-free income but for maintaining the required SLR.

- The tax-free interest is only an incidence on fulfillment of SLR requirements. Then, *section 4A has no application in this case.*

**State Bank of Travancore Vs. Assit. CIT [2009] 318 ITR (AT) 0171- (ITAT-COCHIN )**

# **Existence of exempt income**

If, in a particular year, there is an investment which might yield *exempt income in future*, there can be *no disallowance* under section 14A as there is no exempt income forming part of the total income.

The view expressed in Jt. CIT v. Holland Equipment Co. B.V. [2005] 3 SOT 810 (Mum.), if there is no such exempted income during the year, no disallowance can be made under section 14A.

In Asstt. CIT v. Lafarge India Holding (P.) Ltd. [2008] 19 SOT 121 (Mum.), the assessee had

made investment in shares of various companies out of interest bearing borrowed capital which had yielded no dividend income. It was held that provisions of section 14A could not be applied as there was no exempted income.

# **Non applicability to Chapter VI-A**

➤ The expenditure incurred for earning of export income which is exempt u/s 80HHC, cannot be held to be the income which does not form part of total income. Therefore such expenses cannot be disallowed u/s 14A.

[CIT v. Kings exports 318 ITR 100 (2009) (Punj. & Har.)]

The Tribunal stated that the provisions of section 14A could not be applied to the provisions of Chapter VI-A where deductions are to be made in computing the total income and in no way that can be compared with the exempted income which does not form part of the total income as provided in Chapter III.

[Case law: Asstt. CIT v. Tamil Nadu Silk Producers Federation Ltd. [2006] 103 TTJ (Chennai) 716], [ Asstt. CIT v..Bank of Madura [2011]007 ITR (Trib)0139 ITAT [chen]

Deduction of income derived by a co-operative society u/s 80P of the Income tax Act, 1961 is not a case of “exempt income” but of “deduction from income”. Therefore *provisions of sec.14A are not applicable* in this case.

ACIT Vs. Kribhco 006 ITR 686 (2010) (ITAT-Del)

## **Section 14A in the context of MAT:**

Section 115 JB provides for increasing the book profit by the amount of expenditure relatable to any income to which section 10 [other than 10(38)] applies and reducing the book profit by the amount of income to which section 10 [other than sec. 10(38)] applies. Now that the “method” is in place, the rigmarole of determining the amount of expenditure to be added and year of applicability of the “prescribed method” has to be undergone.



## **Applicability of Provisions of section 271 (1)(c) :**

By applying the prescribed method under rule 8D, addition by way of disallowance of expenditure under section 14A is made, *we have to ascertain whether or not the assessee has furnished inaccurate particulars in the course of assessment proceedings.* If the assessee offers an explanation which is not found by the AO to be false there is no need to invoke this penal provision.

*No Penalty if no disallowance is made in tax audit report*

*Held Nalwa Investments Ltd.: ITA No. 3805(Del)/2010.*

# ISSUES

## *No penalty prior to insertion of Rule 8D*

where the disallowance is made for proportionate expenses claimed in respect of exempted income, no penalty can be levied u/s 271(1)(c) as prior to insertion of Rule 8D by the Finance Act 2008, the question of disallowance and its quantification was contentious.

*ACIT vs M/s Jindal Equipment Leasing & Consultancy Services Ltd. (2011-TIOL-305-ITAT-DEL) ITA No. 3808-3809/Del/2010*

# **Income of an Investment Company**

In case of an investment company, where the business of the company is to invest its funds in the share of sister concerns and other companies and also deposit the money with group concerns on which interest is received, *the infrastructure of the company is utilized for the purpose of carrying out its objects*, i.e., investment in other concerns and also earning income on such investments. In such a case, *assessee is required to furnish details of expenditure incurred on salary of staff utilized for the object of assessee-company, which would be disallowed otherwise it would be disallowed under section 14a on estimate basis.*

Dy.CIT V. Tata Investment Corporation Ltd. (2007) 295 ITR 330(Mum-Trib)

# Whether maintenance of separate books mandatory??????

Section 14A authorises AO to make disallowance of expenditure incurred for earning tax free income, irrespective of whether assessee maintained separate accounts or not with regard to expenditure incurred for earning non-taxable income. CIT v. The catholic Syrian Bank Ltd. [2011] 9 taxmann.com148(KER.)

➤ Non maintenance of separate accounts by assessee with regard to expenditure incurred for earning non-taxable income was not justification to claim immunity from operation of section14A. CIT v. Dhanalakshmy Bank Ltd, [2011] 10 taxmann.com 213(Ker.)

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## **Business income vs. capital gains**

Assessee maintains separate D-mat account for investment and for trading and the shares are duly recorded in the books of account under the head investments and stock in trade. It had maintained the investment portfolio separately, income for which was liable to be taxed as capital gains.

As the intention in respect of this was to hold the investment as investment only, the income will be treated as capital gain

Asstt. CIT v. M/s Bull & Bears Portfolios Ltd., 2011-TIOL-109-ITAT-DEL

# ISSUES

The assessee is maintaining separate books of account for the purpose of business. The tax-free investments are in his personal capacity. As the Assessing Officer has not disallowed any expenditure of personal nature out of the business income, the expenditure claimed in the business of share dealings cannot be correlated to the incomes earned in personal capacity that too on dividend, PPF interest and tax free interest on RBI bonds

Accordingly, the estimation of expenditure out of business expenditure as being incurred for earning tax free income is not acceptable.

Pawan Kumar Parmeshwarlal vs. ACIT, ITA No. 530/Mum/2009, dt. 11-1-2011, ITAT Mumbai 'C'



# **THANK YOU!!!**

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