

Interest on loan for stocks not tax-deductible

Tax laws provide that expenditure incurred in relation to exempt income will not be allowed as a deduction in the hands of the tax payer. The Central Board of Direct Taxes (CBDT), in a recent circular, has further clarified that such deduction will not be allowed against other taxable income, even if the tax payer has in that particular year not earned any exempt income. This clarification has far reaching significance for investors who borrow money for investing in shares and earn tax-exempt dividends.

Given this clarification by the CBDT, even if a shareholder has not earned dividend income in a particular year, the interest paid by him against his loan will not be allowed as a deduction in that year against other components of his taxable income, say income from business or even salary income. Section 14A of the Income Tax (I-T) Act was inserted in 2001 with retrospective effect from April 1, 1962. It provides that if an income is exempt, then any expenditure related to such income would also not be allowed as a deduction. Rule 8D prescribed for the methodology of disallowance, in certain cases.

In addition to dividend income from shares or units of mutual funds, income referred to by section 14A includes agricultural income, income from tax-free bonds and also share of profits earned by a partner of a firm. Expenditure incurred in relation to such income is not allowed as a deduction in the hands of the taxpayer.

Over the past few years, controversies arose on whether the disallowance of expenditure can be made by the tax authorities in a year in which the taxpayer does not earn any exempt income. "If an investor has borrowed to invest in shares, the shares may or may not yield exempt dividend income in a particular financial year (FY). However, interest on the borrowed funds would still have to be paid. Contrary views were taken by tax tribunals and courts on whether the interest would be allowed as a deduction against the taxable income of the investor in that FY when no dividend income was earned," explains Pinakin Desai, partner, EY India.

CBDT, after examining the issue, has clarified that the legislative intent is to allow only that expenditure which is relatable to the earning of income. It, therefore, follows that expenses incurred in relation to exempt income should be disallowed, irrespective of whether any exempt income has been earned in that particular FY or not, CBDT added.

It is important to note that the CBDT circular is binding only on the tax authorities. "But if a taxpayer holds a different view, he should prove that the expenditure claimed by him is not in relation to exempt income. The circular, per se, cannot bind him," explains Desai.

An investment manager says, "Denying of expenditure incurred for purchase of shares is unfair. Even as dividend income is tax-free in the hands of shareholders, the company bears a dividend distribution tax. This impacts the cash flow and resultant payout to the shareholders."

(Economic Times)