

SECTION 14A OF THE INCOME TAX ACT, 1961

BY VIJAY PATEL
INUMULA

Date: 01-Nov-2014

INTRODUCTION

- ▶ Section 14A has been introduced by the Finance Act of 2001 in Chapter IV and has effect from 1-4-1962.
- ▶ To clarify the intention of the legislature with respect to expenses relating to earning of an exempted income.

NATURE AND SCOPE OF SECTION 14A

- ▶ As per Section 14A, expenditure which has a bearing on exempt income should not be considered in the computation of total income as otherwise this would result in double advantage to the assessee
- ▶ Example-1: when agricultural income itself is exempt from taxation, there is no justification to consider expenditure on agricultural activities in the computation of total income.
- ▶ Example-2: company has borrowed a sum of say rupees two crores and pays an annual interest of say rupees two lakhs and at the same time has invested in the shares of another company for about rupees twenty thousand, in such a case the company would receive a **dual benefit** of 2 lakhs and on dividend on the twenty thousand.

APPLICABILITY OF SECTION 14A

- ▶ The following conditions have to be satisfied for the applicability of Section 14A. They are
- ▶ 1. Assessee must have exempted income which is not includable in his total income.
- ▶ 2. Assessee must have incurred expenditure in relation to earning of income which is exempted under Income Tax Act.
- ▶ 3. Whether such income was earned in the specific year in question.

What is exempted income ?

- ▶ Exempted income can be said to be that income which does not form a part of the total income.
- ▶ The best example for exempted income can be agricultural income.
- ▶ Other exempted income can be the income listed in S. 10, S. 10A, S. 10AA, S. 10B, S. 10BA, S. 10C and such other incomes exempted from total income under this Act or any other Act, time being in force.

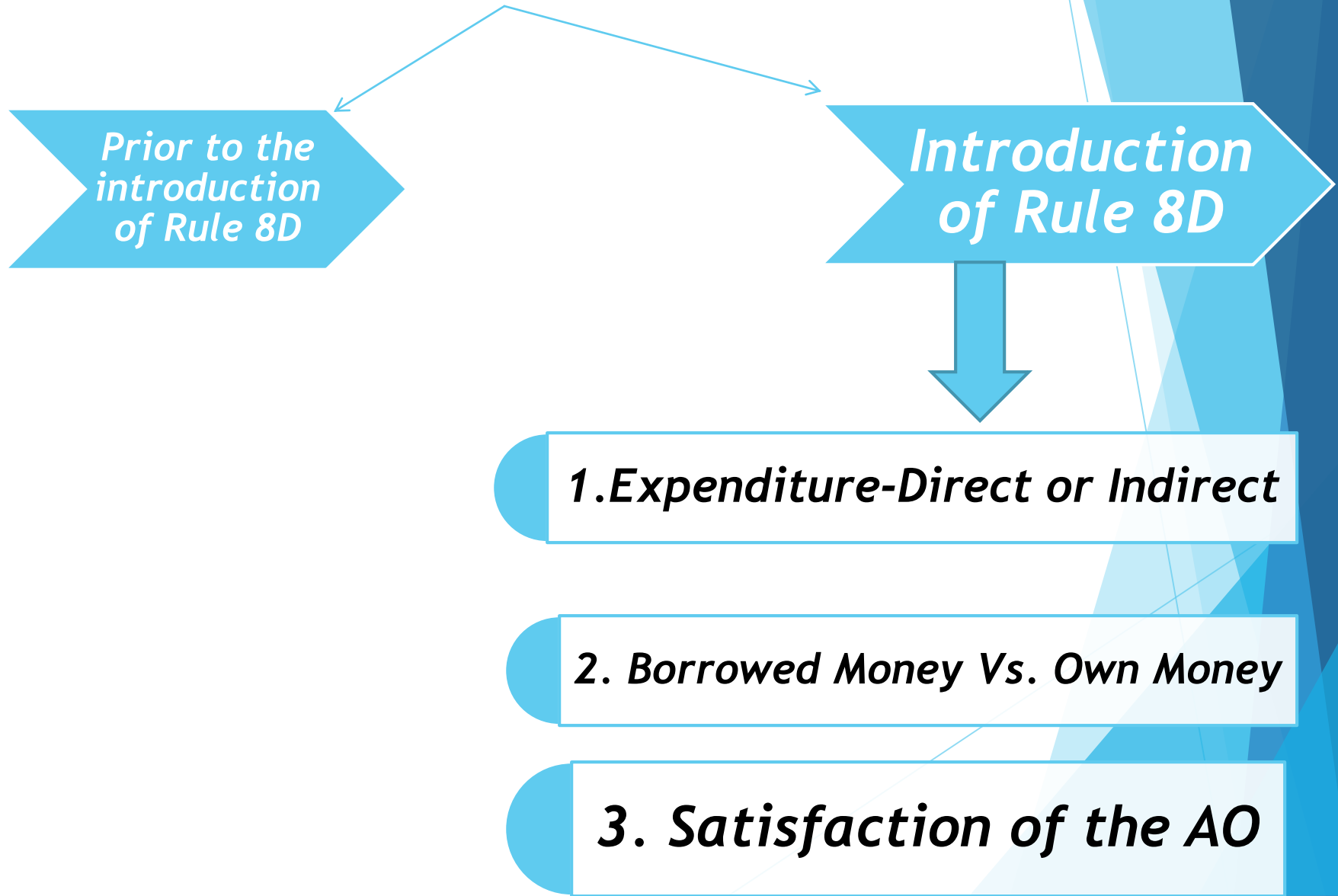
What is incurred expenditure?

- ▶ The term "expenditure" as mentioned in Section 14A would take within its ambit not only direct expenditure but also all forms of expenditure regardless of whether they are fixed, variable, direct, indirect, administrative, managerial or financial

What is specific year in question ?

- ▶ If expenditure is incurred in relation to exempt income, such expense shall be disallowed whether or not such income was earned in the specific year in question.
- ▶ Case Law-1: **Cheminvest Ltd Vs. Income Tax Officer [124 TTJ 577 (Del)(SB)]:-** In this case the assessee had borrowed sums for purchasing shares in the **dual capacity** i.e.as a trader as well as an investor but no dividend was received in the concerned year. The contention of assessee was that since **no income forming part of total income was received**, the question of making any disallowance did not arise. After hearing the arguments of both the sides, it was held that if the expenditure is incurred in relation to income which does not form part of total income, it has to suffer disallowance irrespective of the fact whether any income is earned by the assessee or not

METHOD OF COMPUTING DISALLOWANCE



1. PRIOR TO THE INTRODUCTION OF RULE 8D

- ▶ Prior to the introduction of Rule 8D there was no method in the statute book for computing the expenditure incurred for earning the exempted income. Each Officer applied his own method and there was no uniformity in the manner in which the disallowance was made.

2. Introduction of RULE 8D

- ▶ If one examines Rule 8D, we find that the method for determining the expenditure in relation to exempt income has three components.
- ▶ 1. Amount of **expenditure directly** relating to income which does not form part of the total income.
- ▶ 2. Expenditure computed on the basis of the **formula given** therein in a case where the assessee incurs expenditure by way of interest which is not directly attributable to any particular income or receipt.
- ▶ 3. An artificial figure - **half percent** of the average value of the investment, income from which does not or shall not form part of the total income.
- ▶ The **aggregate of these three components** which would constitute the expenditure in relation to exempt income and it is this amount of expenditure which would be disallowed under section 14A

Rule 8D Calculation- Expenditure-Direct or Indirect

S NO	TYPE OF EXPENDITURE	OP. Bal	Cl. Bal	TOTAL/ AVERAGE
1	Direct Expenditure	0	0	0
2	Expenditure by way of interest (A)			1,00,000
3	Average value of investments (B)(on shares and MF)	8,00,000	12,00,000	10,00,000 (Average)
4	Average of total assets (C)	48,00,000	52,00,000	50,00,000 (Average)
5	An amount equal to one half of average value of total Investments		10,00,000	$\frac{1}{2}$ % of 10,00,000 = 5,000/-

▶ Amount of disallowance for the year =
 $1,00,000 * (10,00,000 / 50,00,000) = 20,000/-$ (A)

▶ 1/2% of the average total assets
 $= \frac{1}{2} \% \text{ of } 10,00,000 = 5,000/-$ (B)

14A Therefore total disallowance under Section 14A=
 $(A) + (B) = 20,000 + 5,000 = 25,000/-$

- ▶ Decisions in favour of the Assessee:
- ▶ a) The Supreme Court in **Munjil Sales Corporation 298 ITR 298** held that where the opening balance of profits of the firm **exceeds** the loans given to sister concerns, then it is presumed that the said loans are given out of its own funds.
- ▶ b), **The Madras High Court in Hotel Savera Vs. CIT 239 ITR796(mad)** ,held that where sufficient own funds of the assessee were available for making investment, it cannot be assumed that any part of investment producing the tax free income must have been from borrowed funds unless there is evidence to show that any specific investment has been made from borrowed funds.

- ▶ When the AO does not accept the assessee's claim regarding the non-applicability/ quantum of disallowance u/s 14A, he has to record satisfaction on that issue. This satisfaction cannot be a plain satisfaction or a simple note. It has to be done with regard to the accounts of the assessee. On facts, as there is no satisfaction by the AO, no disallowance u/s 14A can be made .

WHETHER RULE 8D IS APPLICABLE IN CASE OF INVESTMENTS HELD AS STOCK-IN TRADE?

- ▶ A moot question today is whether Rule 8D will be applicable to investments held as stock in trade, in case, during the year under consideration, the taxpayer had received dividend income from such investment. Now the question is whether while computing the disallowance under Rule 8D stock in trade should be taken into account or not. There is no finality in regards to the said question. Various tribunals and courts have given different decisions in respect of the same question.

- ▶ Section 14A of the Income tax Act, 1961 is not applicable to an insurance business as they are governed under the specific provisions of section 44 of the Income Tax Act, 1961
- ▶ This has been so decided by Pune ITAT in the case of **Bajaj Alliance General insurance Co. Ltd. Vs. Addl. CIT 38 Oriental Insurance Co. Ltd [130 TTJ 388 (Del.) (Trib.)]**. A Delhi bench of ITAT held that Sec 14A was not applicable to insurance companies. ITAT observed that the income of the insurance companies had to be computed u/s 44 read with Rule 5 of the First Schedule to Income Tax Act, which is a specific provision overriding Sec 14A. Since, as per Sec 44 no head-wise bifurcation of income was required to be made in case of insurance companies, Sec 14A disallowance could not be made. ITAT observed, “It is not permissible to the Assessing Officer to travel beyond s. 44 and First Schedule of the Income-tax Act

CONCLUSION

- ▶ In order to avoid unreasonable and ad hoc disallowance by the Assessing Officer, the assessee can disallow in its computation of income, a reasonable amount of expenditure considering the following factors
Quantum of investments made from which exempted income has been Earned
Quantum of dividend income received during the year
Percentage of time spent and salary of an Administrative officer and any other manager for making such investments and earning of such Income
- ▶ A Reasonable Disallowance by the assessee which cannot be found fault with by the Assessing Officer will ensure that rule 8D is not made applicable to the assessee and disallowance more prejudicial to the assessee is not made

THANK YOU

The background features abstract, overlapping geometric shapes in various shades of blue, ranging from light sky blue to deep navy blue. These shapes are primarily located on the right side of the frame, creating a modern, layered effect against the white background.