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Flash News

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Expenditure is to be disallowed under Section 14A in relation to dividend income which is subject to dividend distribution tax – Supreme Court

Background

Recently, the Supreme Court of India in the case of Godrej & Boyce Manufacturing Company Limited[1] (the taxpayer) held that disallowance under Section 14A of the Income-tax Act, 1961 (the Act) would apply to dividend income which is subject to dividend distribution tax (DDT). The same is also clear from a plain and literal reading of Section 14A which is consistent with the Act and the legislature's objective behind introduction of such provisions.

However, in the present case, the Supreme Court did not find any mention of the reasons which lead the Assessing Officer (AO) to hold that certain expenditure has nexus with the dividend income earned by the taxpayer. Further there was no reason to hold that the orders of the Tribunal for the earlier Assessment Years (AYs) were not acceptable, particularly, in the absence of any new fact or change of circumstances. Since there is no change in the facts or law in the relevant AY, the AO was not justified in departing from a settled position of earlier year.

Facts of the case

- The taxpayer is engaged in the business of manufacture of steel furniture, security equipments, typewriters, electrical equipments and a host of other related products. It is also a promoter of various other companies and invests its funds in such companies in order to maintain control of such concerns as sister concerns.
- During the Assessment Year (AY) 2002-2003, the taxpayer filed its return of income declaring a loss. In the said return, it had shown income by way of dividend from companies and income from units of mutual funds.
- For AY 1998-1999, 1999-2000 and 2001-2002, the AO notionally allocated the interest expenditure to the earning of the dividend income and disallowed such interest expenditure and consequently, reduced the exemption available under Section 10(33) of the Act to the net dividend. The taxpayer claimed that the investments were made from interest-free funds in the form of share capital and reserves, no part of borrowed funds were used for making investments. The CIT(A) allowed exemption of the entire dividend income on the ground that the AO had failed to show any nexus between the investments in shares and units of mutual funds on the one hand and the borrowed funds on the other. On further appeal by the tax department, the Tribunal confirmed the order. The said order had attained finality.
- During AY 2002-03, the facts were similar to earlier years. The taxpayer has not made fresh investments during AY 2002-2003, in fact, there is a reduction in the value of investments. The taxpayer had sufficient interest free funds available for the purpose of making investments. However, AO disallowed part of interest expenditure holding the same to be attributable to earning the dividend income.

[1] Godrej & Boyce Manufacturing Company Limited v. DCIT (Civil Appeal No. 7020 of 2011) – Taxsutra.com

- The Commissioner of Income-tax (Appeals) [CIT(A)] deleted the disallowance relying on earlier favourable decision of the Tribunal. On further appeal to the Tribunal, it was held the decision in favour of the tax department holding that sub-sections (2) and (3) of Section 14A of the Act were retrospectively applicable and matter is remanded back to the AO for recording his satisfaction/findings in the light of Section 14A of the Act.
- On appeal to the High Court, the High Court held that Section 14A of the Act has to be construed on a plain grammatical construction thereof and the said provision is attracted in respect of dividend income referred to in Section 115-O as such income is not includible in the total income of the shareholder.
- Against the decision of the High Court, the taxpayer filed an appeal before the Supreme Court.

Supreme Court's decision

Disallowance in respect of exempt dividend income

- The object behind the introduction of Section 14A of the Act by the Finance Act of 2001 is clear and unambiguous. The legislature intended to check the claim of allowance of expenditure incurred towards earning exempted income in a situation where the taxpayer has both exempted and non-exempted income or includible or non-includible income.
- There is no doubt that if the income in question is taxable, it is includible in the total income. The deduction of expenditure incurred in relation to such an income must be allowed.
- On reference to Section 14A of the Act it indicates that the income must not be includible in the total income of the taxpayer. Once the said condition is satisfied, the expenditure incurred in earning the said income cannot be allowed to be deducted.
- The section does not contemplate a situation where even though the income is taxable in the hands of the dividend paying company and the same to be treated as not includible in the total income of the recipient taxpayer, yet, the expenditure incurred to earn that income must be allowed. Such a meaning, if ascribed to Section 14A of the Act, would be plainly beyond what the language of Section 14A can be understood to reasonably convey.
- The decision of K. P. Varghese[2] relied on by the taxpayer is distinguishable on the facts of the present case. The literal meaning of Section 14A of the Act, far from giving rise to any absurdity, appears to be wholly consistent with the scheme of the Act and the object/purpose of levy of tax on income. Therefore, the well-entrenched principle of interpretation that where the words of the statute are clear and unambiguous, recourse cannot be made to principles of interpretation. The Supreme Court also referred various decisions[3].
- The provisions of Section 10(33) of the Act should be read in the light of Section 115-O of the Act. In so far as the types of dividend income on which tax is payable under Section 115-O of the Act is concerned, the earning of the said dividend is tax free in the hands of the taxpayer and not includible in the total income of the said taxpayer. Therefore, Section 14A of the Act would not apply to such dividend income.
- Section 10(33) and Section 115-O of the Act were brought in together; deleted and reintroduced later in a composite manner, also, does not assist the taxpayer. In so far as the dividend income is taxable in the hands of the dividend paying company, the same is not includible in the total income of the recipient taxpayer.
- So far as the provisions of Section 115-O of the Act are concerned, even if it is assumed that the additional income tax under the aforesaid provision is on the dividend and not on the distributed profits of the dividend paying company, no material difference to the applicability of Section 14A would arise. Sub-sections (4) and (5) of Section 115-O of the Act clearly provides that the further benefit of such payments cannot be claimed either by the dividend paying company or by the taxpayer.
- The provisions of Sections 194, 195, 196C and 199 of the Act, would further fortify the fact that the dividend income under Section 115-O of the Act is a special category of income which has been treated differently by the Act making the same non-includible in the total income of the recipient taxpayer as tax thereon had already been paid by the dividend distributing company.

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[2] K.P. Varghese v. ITO [1981] 131 ITR 597 (SC)
[3] CIT v. Calcutta Knitwears [2014] 6 SCC 444, Income-Tax v. Tara Agencies [2007] 292 ITR 444 (SC), Cape Brandy Syndicate v. IRC [1921] 1 KB 64

- The other species of dividend income which attracts levy of income tax at the hands of the recipient taxpayer has been treated differently and made liable to tax under the provisions of the Act. In fact, if the argument is that tax paid by the dividend paying company under Section 115-O of the Act is to be understood to be on behalf of the recipient taxpayer, the provisions of Section 57 of the Act should enable the taxpayer to claim deduction of expenditure incurred to earn the income on which such tax is paid. Such a position in law would be wholly incongruous in view of Section 10(33) of the Act.

- The Supreme Court in the case of Walfort Share and Stock Brokers P. Ltd.[4] noticing the objects and reasons behind introduction of Section 14A of the Act, held that expenses allowed can only be in respect of earning of taxable income.

- Accordingly, it has been held that Section 14A of the Act would apply to dividend income which is subject to dividend distribution tax.

Applicability of Section 14A of the Act to the facts of the present case

- Section 14A as originally enacted by the Finance Act of 2001 with effect from 1 April 1962 is in the same form and language as currently appearing in Section 14A(1) of the Act. Sections 14A(2) and (3) of the Act were introduced by the Finance Act 2006 with effect from 1 April 2007.

- The issue with respect to Section 14A of the Act stands concluded in its favour in respect of the Assessment Years 1998-1999, 1999-2000 and 2001-2002. Earlier to the introduction of sub-sections (2) and (3) of Section 14A of the Act, such a determination was required to be made by the AO in his best judgment. In all the aforesaid AYs it was held that the tax department had failed to establish any nexus between the expenditure disallowed and the earning of the dividend income in question.

- In some of the AYs, the aforesaid question was specifically looked into from the standpoint of the requirements of the provisions of sub-sections (2) and (3) of Section 14A of the Act which had by then been brought into force. It is on such consideration that findings have been recorded that the expenditure in question bore no relation to the earning of the dividend income and hence the taxpayer was entitled to the benefit of full exemption claimed on account of dividend income.

- In view of the above, a different view cannot be taken for the AY 2002-2003. Sub-sections (2) and (3) of Section 14A of the Act read with Rule 8D of the Rules merely prescribe a formula for determination of expenditure incurred in relation to income which does not form part of the total income under the Act in a situation where the AO is not satisfied with the claim of the taxpayer.

- Whether such determination is to be made on application of the formula prescribed under Rule 8D or in the best judgment of the AO, what the law postulates is the requirement of a satisfaction in the AO that having regard to the accounts of the taxpayer, as placed before him, it is not possible to generate the requisite satisfaction with regard to the correctness of the claim of the taxpayer. It is only thereafter the provisions of Section 14A(2) and (3) read with Rule 8D of the Rules or a best judgment determination, as earlier prevailing, would become applicable.

- In the present case, the Supreme Court did not find any mention of the reasons which had prevailed upon the AO, while dealing with the AY 2002-2003, to hold that the claims of the taxpayer that no expenditure was incurred to earn the dividend income cannot be accepted and why the orders of the Tribunal for the earlier AYs were not acceptable to the AO, particularly, in the absence of any new fact or change of circumstances.

- Neither any basis has been disclosed establishing a reasonable nexus between the expenditure disallowed and the dividend income received. Any part of the borrowings of the taxpayer had been diverted to earn tax free income despite the availability of surplus or interest free funds available remains unproved by any material whatsoever.

- While it is true that the principle of *res judicata* would not apply to assessment proceedings under the Act, the need for consistency and certainty and existence of strong and compelling reasons for a departure from a settled position has to be spelt out which conspicuously is absent in the present case. In this regard the decision the Supreme Court in the case of Radhasoami Satsang[5].

[4] Walfort Share and Stock Brokers P. Ltd. [2010] 326 ITR 1 (SC)

[5] Radhasoami Satsang v. Commissioner of Income-Tax [1992] 193 ITR 321 (SC)

- Accordingly, it has been held that for the AY 2002-2003, no disallowance shall be made under Section 14A of the Act.

Our analysis

Whether dividend received post DDT paid by the company, will trigger disallowance of expenditure under Section 14A of the Act

As per the provisions of Section 115-O of the Act, the tax is being deducted by the company out of dividend declared, distributed or paid to the shareholder. Thus, the dividend income, which belongs to the shareholder has suffered tax either in the hands of the company or in the hands of the shareholder. Therefore, whether it can be said that the dividend income received by the shareholder is exempt and the only difference, which has been made by the provisions of Section 115-O is that the incidence of tax is shifted from the shareholder to the company.

The Mumbai Tribunal in the case of Mafatlal Holdings Ltd[6] dealt with this issue and held that the dividend income received by the taxpayer is in fact not exempt from tax but the incidence of tax has been shifted from the shareholder to the company. Ultimately it is the income of the shareholder, which is being assessed either in his own hands or in the hands of the company. The contention of the tax department that the dividend income is exempted from tax and, therefore, no expenditure can be allowed against that income is without any substance. Therefore, no disallowance can be made under Section 14A of the Act. The Mumbai Tribunal in Admo Holdings[7] also held on similar lines.

On the other hand the Hyderabad Tribunal in the case of Mohan T. Advani Finance Ltd[8] observed that while dealing with taxable and non-taxable income for the purpose of Section 14A one has to look the nature of receipts in the hands of the recipient and not in the hands of the payer. If income is non-taxable in the hands of the recipient, the provisions of Section 14A would certainly apply and expenditure incurred in earning that non-taxable income will not be allowed to be deducted against the taxable income. If it is permitted it would be a violence to the newly inserted Section 14A of the Act. Subsequently, various Courts/Tribunal have held on similar lines[9].

The Supreme Court, in the instant case, has dealt with this issue and held that the object behind the introduction of Section 14A of the Act by the Finance Act of 2001 is clear and unambiguous. A plain reading of Section 14A would go to show that the exempt income must not be includible in the total income of the taxpayer. Once the said condition is satisfied, the expenditure incurred in earning the said income cannot be allowed to be deducted. Since the dividend income on which tax is payable under Section 115-O of the Act is concerned, the earning of the said dividend is tax free in the hands of the taxpayer and not includible in the total income of the said taxpayer. Therefore, disallowance under Section 14A of the Act would apply to such dividend income.

The meaning of term 'in relation to'

Section 14A of the Act provides that 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 the Act. The issue for consideration is what is the meaning of the term 'in relation to' under Section 14A of the Act.

The Delhi High Court in the case of Maxopp relied on the Supreme Court's decision in the case of Doypack Systems Pvt Ltd[10] and observed that the expression 'in relation to' (so also 'pertaining to'), is a very broad expression which presupposes another subject matter. These are words of comprehensiveness which might both have a direct significance as well as an indirect significance depending on the context. Further, relying on Corpus Juris Secundum[11], it was observed that the term 'relating to' has been held to be equivalent to or synonymous with as to 'concerning with' and 'pertaining to'. The expression 'pertaining to' is an expression of expansion and not of contraction. The High Court held that the expression 'in relation to' appearing in Section 14A of the Act cannot be ascribed a narrow or constricted meaning. The expression 'in relation to' does not have any embedded object. It simply means 'in connection with' or 'pertaining to'. If the expenditure in question has a relation or connection with or pertains to exempt income, it cannot be allowed as a deduction even if it otherwise deductible under the other provisions of the Act.

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[6] Mafatlal Holdings Ltd. v. ACIT [2014] 85 TTJ 821 (Mum)
[7] Admo Holdings (P) Ltd v. JCIT (ITA No. 2151 of 2001) (Mum)
[8] Mohan T. Advani Finance Ltd [2007] 108 TTJ 0170 (Hyd)
[9] Godrej and Boyce Mg. Co Ltd v. DCIT [2010] 194 Taxman 203 (Bom), Sunash Investment Co. v. ACIT [2007] 14 SOT 80 (Mum), Harish Krishnakant Bhatt v. ITO [2004] 91 ITD 311 (Ahd)

[10] Doypack Systems Pvt Ltd v. Union of India [AIR 1988 SC 782]
[11] Encyclopedia of US Law

Nexus of expenditure with exempt income

The Supreme Court observed that in the earlier assessment years, the tax department had failed to establish any nexus between the expenditure disallowed and the earning of the dividend income and therefore no disallowance was made in those years. Accordingly, since there is no change in the facts of the case, no disallowance was made under Section 14A of the Act for the relevant AY.

The Punjab and Haryana High Court in the case of Hero Cycles Ltd[12] held that the contention of the tax department that directly or indirectly some expenditure is always incurred which must be disallowed under Section 14A cannot be accepted. Disallowance under Section 14A requires finding of incurring of expenditure; where it is found that for earning exempt income no expenditure has been incurred, disallowance under Section 14A cannot be made.

However, the above decisions pertain to the assessment years before the introduction of Rule 8D in the Income-tax Rules, 1962.

Section 14A(2) provides that the Assessing Officer (AO) 'shall' determine the amount of expenditure incurred in relation to exempt income in accordance with such method as may be prescribed. By using the word 'shall', the legislature has made it mandatory for the AO to determine the amount of expenditure incurred in relation to exempt income as per the prescribed method i.e. Rule 8D[13].

In terms of the said rule, the amount of expenditure in relation to exempt income has two aspects - (a) direct and (b) indirect. The direct expenditure is straightaway taken into account by virtue of Rule 8D(2)(i). The 'indirect expenditure' is to be calculated under Rule 8D(2)(ii) at specified per cent of the average value of the investment, income from which does not or shall not form part of the total income. These indirect expenditure are adhoc disallowance at the specified rate which may/may not have any nexus with the exempt income.

One more issue for consideration is whether after introduction of Rule 8D, the AO has power to disallow specified percentage of indirect expenditure irrespective of whether such expenditure has any nexus with earning of exempt income.

The Delhi High Court in the case of Bharti Overseas Ltd[14] held that the object behind Section 14A(1) is to disallow only such expenditure which is relatable to tax exempt income and not expenditure in relation to any taxable income. For Rule 8D(2)(ii) to apply there has to be some expenditure by way of interest which is not directly attributable to any particular income or receipt. If there is no such expenditure, then the question of applying the formula thereunder will not arise.

The Chennai Tribunal in the case of Allied Investments Housing P Ltd.[15] held that the onus is on the AO to show that expenditure has been incurred by the taxpayer for earning tax-free income. Without discharging the onus, the AO is not entitled to make an ad hoc disallowance. A clear finding of incurring of expenditure is necessary. No disallowance can be made on the basis of presumptions that some interest expenditure were incurred. It cannot be the reason for disallowance unless the nexus between the expenditure and the exempt income is established. In the instant case, the AO has not pointed out any direct nexus between the interest expenditure incurred and the exempt income earned during the year.

Summing up

The issue with respect to disallowance of expenditure under Section 14A vis-à-vis exempt dividend which is subject to DDT has been a matter of debate before the Courts/Tribunal. The Supreme Court in the present case has settled this issue and held that the fact that the dividend income is subjected to DDT in hands of the company is not a relevant circumstance to allow deduction of expenditure in the hands of shareholder and since such dividend does not form part of total income, expenditure relating to such income would be disallowed under Section 14A of the Act.

However, the Income Tax Simplification Committee set up by the government had recommended in its first report published in 2016 that the tax provisions should be designed on the basis of economic taxation and expenditure incurred in connection with earning dividend income, which is subjected to DDT, should not suffer any disallowance.

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[12] CIT v. Hero Cycles Ltd. [2010] 323 ITR 518 (P&H)
[13] Dhampur Sugar Mills Ltd. v. CIT [2014] 51 taxmann.com 508 (All), Joint Investment (P.) Ltd. v. ACIT [2014] 50 taxmann.com 271 (Del)

[14] Pr. CIT v. Bharti Overseas Pvt Ltd [TS-5587-HC-2015(Del)]
[15] DCIT ***v.*** Allied Investments Housing P Ltd. **(Chen)** [AY 2009-10]

It is also pertinent to note that the above referred decisions does not deal with Rule 8D(2)(iii) which provides for apportionment of general indirect expenditure. Rule 8D has been amended with effect from 2 June 2016 where subclause (ii) and (iii) of Rule 8D(2) have been omitted and new clause (ii) has been introduced which provides that the expenditure in relation to income which does not form part of the total income shall be aggregate of direct expenditure and an amount equal to one per cent of the annual average of the monthly averages of the opening and closing balances of the value of investment, income from which does not or shall not form part of total income.

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