



Disallowance under Section 14A of the Income-tax Act is applicable to expenditure in relation to exempt income from strategic investment/stock-in-trade - Supreme Court

Background

The Supreme Court in the case of Maxopp Investment Ltd (the taxpayer) held that disallowance under Section 14A of the Income-tax Act, 1961 (the Act) is applicable to expenditure relating to exempt income from strategic investment/stock-in-trade. The Supreme Court observed that the dominant purpose for which the investment into shares is made by the taxpayer may not be relevant. The taxpayer may have made the investment in order to gain control of the investee company or to ultimately trade those shares by selling them to earn profits. However, that does not appear to be a relevant factor in determining the issue. If expenditure is incurred on earning exempt income, then such expenditure which is attributable to the exempt income has to be disallowed and cannot be treated as business expenditure.

Facts of the case

- The taxpayer is engaged, *inter alia*, in the business of finance, investment and dealing in shares and securities. The taxpayer holds shares/securities in two portfolios, viz. (a) as investment on capital account (b) as trading assets for the purpose of acquiring and retaining control over investee group companies, particularly Max India Ltd., a widely held quoted public limited company.
- Any profit/loss arising on sale of shares/securities held as 'investment' is returned as income under the head 'capital gains', whereas profit/loss arising on sale of shares/securities² held as 'trading assets' has been regularly offered and assessed to tax as business income under the head 'profits and gains of business or profession'.
- During the Assessment Year (AY) 2002-03, the taxpayer filed return declaring income of INR7.89 million. No part of the interest expenditure of INR11.62 million debited to the profit and loss account, to the extent relatable to investment in shares of Max India Limited, yielding tax free dividend income, was considered for disallowance under Section 14A of the Act on the ground that shares in the said company were acquired for the purposes of retaining controlling interest and not with the motive of earning dividend.
- The taxpayer claimed that the dominant purpose/intention of investment in shares of Max India Ltd. was acquiring/retaining controlling interest therein and not earning dividend and, therefore, dividend of INR4.99 million earned on shares of Max India Ltd. during the relevant previous year was only incidental to the holding of such shares.
- The Assessing Officer (AO) worked out disallowance under Section 14A of the Act at INR6.77 million by apportioning the interest expenditure of INR11.62 million in the ratio of investment in shares of Max India Ltd. (on which dividend was received) to the total amount of unsecured loan. However, the AO restricted disallowance under that Section to INR4.99 million being the amount of dividend received and claimed exempt.
- The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO.
- The Special Bench of Tribunal held that investment in shares representing controlling interest did not amount to carrying on of business and, therefore, interest expenditure incurred for acquiring shares in group companies was hit by the provisions of Section 14A of the Act. Further, the Special Bench held that holding of shares with

¹ Maxopp Investment Ltd v. CIT (Civil Appeal Nos 104-109 of 2015) – Taxsutra.com

² Which is held, *inter alia*, with the intention of acquiring, exercising and retaining control over investee group companies

the intention of acquiring/retaining controlling interest would normally be on capital account, i.e. as investment and not as "trading assets". For that reason too, the Special Bench held that there existed dominant connection between interest paid on loan utilised for acquiring the aforesaid shares and earning of dividend income. Consequently, the provisions of Section 14A of the Act were held to be attracted. On the interpretation of the expression 'in relation to', the majority opinion of the Special Bench was that the requirement of there being direct and proximate connection between the expenditure incurred and exempt income earned could not be read into the provision. What is relevant is to work out the expenditure in relation to the exempt income and not to examine whether the expenditure incurred by the taxpayer has resulted into exempt income or taxable income.

- The Delhi High Court held that the expression 'in relation to' appearing in Section 14A of the Act was synonymous with 'in connection with' or 'pertaining to', and the provisions of that Section apply regardless of the intention/motive behind making the investment. As a consequence, proportionate disallowance of the expenditure incurred by the taxpayer is maintained.

Supreme Court decision

Shares held as controlling interest in investee companies

- It is that expenditure alone which has been incurred in relation to the income which is not includible in total income that has to be disallowed. If an expenditure incurred has no causal connection with the exempted income, then such an expenditure would obviously be treated as not related to the income that is exempted from tax, and such expenditure would be allowed as business expenditure. To put it differently, such expenditure would then be considered as incurred in respect of other income which is to be treated as part of the total income.
- There is no quarrel in assigning this meaning to Section 14A of the Act. In fact, all the High Courts, whether it is the Delhi High Court³ on the one hand or the Punjab and Haryana High Court⁴ on the other hand, have agreed in providing this interpretation to Section 14A of the Act. The entire dispute is as to what interpretation is to be given to the words 'in relation to' in the given scenario, viz. where the dividend income on the shares is earned, though the dominant purpose for subscribing in those shares of the investee company was not to earn dividend.
- It has been observed that the dominant purpose for which the investment into shares is made by the taxpayer may not be relevant. No doubt, the taxpayer may have made the investment in order to gain control of the investee company. However, that does not appear to be a relevant factor in determining the issue in the present case. Fact remains that such dividend income is non-taxable.
- In this scenario, if expenditure is incurred on earning the dividend income that much of the expenditure which is attributable to the dividend income has to be disallowed and cannot be treated as business expenditure. Keeping this objective behind Section 14A of the Act in mind, the said provision has to be interpreted, particularly, the word 'in relation to the income' that does not form part of total income. The principle of apportionment of expenses comes into play as that is the principle which is engrained in Section 14A of the Act⁵.
- The Delhi High Court, therefore, correctly observed that prior to introduction of Section 14A of the Act, the law was that when an taxpayer had a composite and indivisible business which had elements of both taxable and non-taxable income, the entire expenditure in respect of said business was deductible and, in such a case, the principle of apportionment of the expenditure relating to the non-taxable income did not apply.
- The principle of apportionment was made available only where the business was divisible. It is to find a cure to the aforesaid problem that the Legislature has not only inserted Section 14A by the Finance (Amendment) Act, 2001 but also made it retrospective, i.e., 1962 when the Act itself came into force. The aforesaid intent was expressed loudly and clearly in the Memorandum explaining the provisions of the Finance Bill, 2001.
- The Supreme Court agreed with the view taken by the Delhi High Court, and are not inclined to accept the opinion of Punjab & Haryana High Court which went by dominant purpose theory. The aforesaid reasoning would be applicable in cases where shares are held as investment in the investee company, may be for the purpose of having controlling interest therein. Accordingly, appeals of the taxpayer as well as similar cases where shares were purchased by

⁵ CIT v. Walfort Share and Stock Brokers P Ltd [2010] 326 ITR 1 (SC)

³ Maxopp Investment Ltd [2011] 347 ITR 272 (Del)

⁴ PCIT v. State Bank of Patiala [2017] 391 ITR 218 (P&H)

the taxpayers to have controlling interest in the investee companies have to be dismissed.

Shares held as stock in trade

- The CBDT has issued Circular⁶ wherein the decision of the Supreme Court in Nawanshahar⁷ referred. The Supreme Court in that case held that investments made by a banking concern are part of the business or banking and income arises from such investments treated as 'profits and gains of business and profession'. The CBDT relying on the decision of Nawanshahar clarified such income is to be treated as 'profits and gains of business and profession'.
- The Punjab and Haryana High Court observed that the CBDT circular carves out a distinction between 'stock-in-trade' and 'investment' and provides that if the motive behind purchase and sale of shares is to earn profit, then the same would be treated as trading profit and if the object is to derive income by way of dividend then the profit would be said to have accrued from investment. To this extent, the High Court may be correct. However, the Supreme Court in the present case did not agree with the test of dominant intention applied by the Punjab and Haryana High Court. In that event, the question is as to on what basis those cases are to be decided where the shares of other companies are purchased by the taxpayers as 'stock-in-trade' and not as 'investment'.
- In those cases, where shares are held as stock-in-trade, the main purpose is to trade in those shares and earn profits therefrom. However, the Supreme Court are not concerned with those profits which would naturally be treated as 'income' under the head 'profits and gains from business and profession'. When the shares are held as 'stock-in-trade', certain dividend is also earned, though incidentally, which is also an income. However, by virtue of Section 10(34) of the Act, this dividend income is not to be included in the total income and is exempt from tax. This triggers the applicability of Section 14A of the Act which is based on the theory of apportionment of expenditure between taxable and non-taxable income as held in Walfort Share and Stock Brokers P Ltd. case. Therefore, to that extent, depending upon the facts of each case, the expenditure incurred in acquiring those shares will have to be apportioned and disallowed.
- The Supreme Court observed that in the case of State Bank of Patiala, the AO had already restricted the disallowance to the amount which was claimed as exempt income by applying the formula contained in Rule 8D of the Income-tax Rules, 1962 (the Rules) holding that Section 14A of the Act would be applicable. Despite this, the CIT(A) disallowed the entire deduction of expenditure. However, the Tribunal rightly set aside that view of the CIT(A) which was clearly untenable. Therefore, on facts,

the Punjab and Haryana High Court has arrived at a correct conclusion by affirming the view of the Tribunal, though the Supreme Court are not subscribing to the theory of dominant intention applied by the High Court.

- In the result, the appeals filed by the tax department challenging the decision of the Punjab and Haryana High Court in State Bank of Patiala also fail, though law in this respect has been clarified. Having regard to the language of Section 14A(2) of the Act, read with Rule 8D of the Rules, the Supreme Court also make it clear that before applying the theory of apportionment, the AO needs to record satisfaction that having regard to the kind of the taxpayer, suo moto disallowance under Section 14A was not correct.
- It will be in those cases where the taxpayer in his return has himself apportioned but the AO was not accepting the said apportionment, the AO have to record its satisfaction to this effect. Further, while recording such a satisfaction, nature of loan taken by the taxpayer for purchasing the shares/making the investment in shares is to be examined by the AO.

Applicability of Rule 8D

- Rule 8D of the Rules is prospective in nature and could not have been made applicable in respect of the Assessment Years prior to 2007 when this Rule was inserted. This view has already been upheld by the Supreme Court in the case of Essar Teleholdings Ltd.⁸

Our comments

The issue with respect to disallowance under Section 14A of the Act of expenditure related to exempt income has been a matter of debate since introduction of Section 14A in the Act. While dealing with the disallowance under Section 14A of the Act vis-à-vis strategic investment/stock-in-trade, the courts⁹ have held that the intention behind purchase of shares/stock was not to earn dividend. The intention was either to hold investment for strategic purpose to control the business in the company in which shares were invested or for business purpose to earn gain from increase in the value of shares. Therefore, disallowance under Section 14A is not warranted.

The Supreme Court in the present case dealt with this issue and relevant judicial precedents and concluded the matter in favour of tax department. The Supreme Court interpreted Section 14A of the Act in a strict manner to held that dominant or main object would not be a relevant consideration for disallowance under Section 14A of the Act. If expenditure is incurred on earning the dividend income, then such expenditure which is attributable to the dividend income has to be disallowed and cannot be treated as business expenditure.

⁶ CBDT Circular No. 18/2015, dated 2 November 2015

⁷ CIT v. Nawanshahar Central Co-op. Bank Ltd [2012] 349 ITR 689 (SC)

⁸ CIT v. Essar Teleholdings Ltd (Civil Appeal No. 2165 of 2012, 31 January 2018)

⁹ PCIT v. State Bank of Patiala [2017] 391 ITR 218 (P&H), CCI Ltd v. JCIT [2012] 250 CTR 291 (Kar), DCIT v. M/s Development Consultant Pvt. Ltd. (ITA No. 213/Kol/2016)

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