



If a tax officer finds the claim of expenditure incurred in relation to exempt income is incorrect, Rule 8D can be invoked even if the incorrect claim or disallowable expenditure is not quantified

Background

Recently, the Punjab and Haryana High Court in the case of Punjab Tractors Ltd.¹ (the taxpayer) held that an Assessing Officer (AO) can resort to Rule 8D of the Income-tax Rules, 1962 (the Rules) only if he/she is not satisfied with the correctness of the taxpayer's claim in respect of the expenditure in relation to the income which does not form part of the total income under the Income-tax Act, 1961 (the Act).

It is mandatory for the AO to record in writing the reasons, having regard to the accounts of the taxpayer, he/she is not satisfied with the correctness of the claim of the taxpayer.

It is reasonable to presume that a large investment would require the deployment of the taxpayer's intellectual, physical and financial resources. It is sufficient if the AO comes to the conclusion that the claim of the taxpayer in this regard is not correct. It is not necessary for the AO to decide the extent or the quantum of the incorrect claim, or quantify the amount disallowable under Section 14A of the Act, prior to the invocation of Rule 8D of the Rules.

Facts of the case

- The taxpayer derives income from the manufacturing and sale of tractors, its components/spares, etc.
- In relation to the Assessment Year (AY) 2008-09, the taxpayer filed its return of income declaring certain business income. The Assessing Officer (AO) rejected the taxpayer's contention that no expenditure was incurred for earning the dividend income as he/she has received the dividend by Electronic Clearance Service credit.
- The AO held that the taxpayer had invested in different securities, which being volatile in nature required the taxpayer to keep a constant vigil on the movements of prices as well as the financial group viability of the company. The taxpayer had deployed sufficient staff and officers to handle its investment portfolio incurring substantial amount of expenditure for various operations. However, the taxpayer did not provide separate details of the expenses relating to dividend income. The AO treated the income earned as the criteria to estimate expenses incurred to earn the exempt income.
- The Commissioner of Income-tax (Appeals) [CIT(A)] held that the expenditure is incurred for composite activities in which taxable and non-taxable income is received. The CIT(A) directed the AO to apply Rule 8D of the Rules to compute the disallowance under Section 14A.

¹ Punjab Tractors Ltd. v. CIT [Income Tax Appeal No.458 of 2015 (O&M), Dated 3 February 2017 – taxsutra.com]

- The Income-tax Appellate Tribunal (the Tribunal) observed that the investments in shares and mutual fund by the corporate sector requires big financial efforts and are handled by the treasury operations department. It cannot be said that no expenditure is incurred for making investments and receiving dividends. Rule 8D has been rightly invoked by the CIT(A).

High Court's decision

The AO can invoke Rule 8D if he/she is not satisfied with the taxpayer's claim

- Under subsections (2) and (3) of Section 14A, an AO can resort to Rule 8D only if he is not satisfied with the correctness of the taxpayer's claim in respect of the expenditure in relation to the income which does not form part of the total income under the Act or if he/she is not satisfied with the correctness of the taxpayer's claim that no expenditure has been incurred by him/her in relation to such income.
- It is not necessary that the conditions specified both in sub-section (2) and sub-section(3) must be satisfied in order to enable the AO to invoke Rule 8D.
- This view is supported by decisions of the Bombay High Court in the case of Godrej and Boyce Mfg. Co. Ltd.² and of the Delhi High Court in the case of Maxopp Investment Ltd.³. In the present case, the High Court, is in agreement with the decisions of these High Courts in this regard.

The AO has to record reasons for not being satisfied with the taxpayer's claim

- It is mandatory for the AO to record that having regard to the accounts of the taxpayer if he/she is not satisfied with the correctness of the claim of the taxpayer in respect of such expenditure in relation to income, which does not form part of the total income under the Act, or that he/she is not satisfied with the taxpayer's claim that no expenditure had been incurred by him/her in relation to the income, which does not form part of the total income under the Act.

- This matter stands concluded by a decision of the Punjab & Haryana High Court in the case of Abhishek Industries Ltd.⁴. The decision in the case of Maxopp Investment Ltd. also supports the view, and such rejection must be for disclosed cogent reasons. However, the disclosure can only be in writing.
- The taxpayer is entitled to test the basis of the rejection of his/her contentions. This can be done only if the AO records his/her reasons for his/her not being satisfied in writing.

The AO has disclosed cogent reasons for invoking Rule 8D

- In relation to the disclosure of cogent reasons for invoking Rule 8D, the AO concluded this aspect by observing that the taxpayer had deployed sufficient staff/officers to handle its investment portfolio for which it would have incurred substantial expenditure for various operations.
- The AO came to the conclusion that a decision to invest a large amount of about INR1.5 billion would require not merely the funds but also the deployment and use of the taxpayer's administrative machinery. It is reasonable to presume that an investment of this nature would require the deployment of the taxpayer's intellectual, physical and financial resources.
- In the case of Hero Cycles Ltd.⁵, the High Court considered a case under Section 80M of the Act, and its ratio would apply equally to Section 14A of the Act. In that case, the High Court observed that even if the investments yielding dividend are in group companies, it cannot be said that no expenditure is incurred for making such investments. In such cases, there would arise a justifiable presumption that some expenditure would be required for the purpose of earning dividend on such investments. The onus would then

² Godrej and Boyce Mfg. Co. Ltd. v. DCIT [2010] 328 ITR 81 (Bom)

³ Maxopp Investment Ltd. v. CIT [2012] 347 ITR 272 (Del)

⁴ CIT v. Abhishek Industries Ltd. [2006] 156 Taxman 257 (P&H)

⁵ CIT v. Hero Cycles Ltd. [2016] 74 Taxmann.com 254 (P&H)

shift to the taxpayer to establish that no expenditure whatsoever was incurred for earning the dividend. Therefore, the AO was justified in concluding that the taxpayer had incurred expenditure towards earning the dividend.

- Till the above observations are set-aside by the Supreme Court or by a larger bench of this Court, this Court is bound by the same.
- In the case of Winsome Textile Industries⁶, the question of administrative expenses and the effect thereof on Section 14A was neither raised before nor decided by this Court. This High Court's decision in the case of Hero Cycles Ltd.⁷, cannot be held to be *per-incuriam* in view of the decision in the case of Winsome Textile Industries.
- For the same reason, the decision of the High Court in the case of Hero Cycles Ltd.⁸ cannot be said to be *per-incuriam*, in view of the decision in the case of Hero Cycles Ltd.⁹. In that case, the Tribunal held that it did not find any evidence to show that the taxpayer had incurred interest expenditure in relation to earning tax exempt income. Therefore, there was no nexus established by the tax department, and on a mere presumption the provisions of Section 14A cannot be applied.
- In the present case, the High Court held that the above observations are in the context of the nature of the funds utilised/deployed for the purpose of making investments. In the case of Hero Cycles Ltd., the Division Bench did not deal with the issue of administrative expenses.

Without determining the quantum of expenditure incurred for earning exempt income, Rule 8D can be applied

- It is sufficient if the AO comes to the conclusion that the claim of the taxpayer in this regard is not correct. It is not necessary for him/her to decide the extent or the quantum of the incorrect claim.

- The language of Section 14(2) is 'is not satisfied with the correctness of the claim' and not 'reasonably doubts it' or 'has reasons to doubt the correctness of the claim'.
- The term 'determination' in Section 14A(2) applies to the computation of the expenditure incurred in relation to exempt income by resorting to the method as may be prescribed, which is Rule 8D. The AO is not required to quantify the amount prior to the invocation of Rule 8D.
- For an AO not to be satisfied with the correctness of the claim of the taxpayer, it is not necessary for him to determine the expenditure incurred for earning the exempt income. Indeed, if that were so, Rule 8D would be redundant.
- It is sufficient for the AO to come to the conclusion that the claim of the taxpayer is not correct. It is not necessary, however, for him/her to determine the extent to which it is incorrect in order to resort to Rule 8D.
- There would be several instances where an AO can come to the conclusion that the claim is incorrect but would be unable to assess the extent of the inaccuracy. That is precisely the purpose of Rule 8D.
- For instance in the present case, the AO was entitled to presume that a part of the expenses from the common fund are attributable to the expenditure incurred for earning the exempt income. He/she was entitled to resort to Rule 8D without determining the amount expended by the taxpayer towards earning the exempt income. Indeed if he/she could have done so, it would not have been necessary for him/her to resort to Rule 8D at all.
- The AO can on the basis of inferences, adverse inferences and reasonable presumptions come to the conclusion that the claim of the taxpayer in relation to such expenditure is not correct.

⁶ CIT v. Winsome Textile Industries [2009] 319 ITR 204 (P&H)

⁷ CIT v. Hero Cycles Ltd. [2010] 323 ITR 518 (P&H)

⁸ CIT v. Hero Cycles Ltd. [2016] 74 Taxmann.com 254 (P&H)

⁹ CIT v. Hero Cycles Ltd. [2010] 323 ITR 518 (P&H)

- The AO on not being satisfied with the correctness of the claim by the taxpayer in respect of the expenditure incurred to earn exempt income ought to have applied Rule 8D which he/she did not. Instead, the AO made an estimate on the basis that he/she considered to be reasonable, which he/she was not entitled to do.
- Where the AO is not satisfied with the correctness of the claim of the taxpayer, in this regard, he/she is bound by the provisions of sub section (2) of Section 14A to follow the prescribed method which at the relevant time was Rule 8D.
- The computation under Rule 8D shall be carried out in the first instance by the AO. The parties are always at liberty to question the same in accordance with law.
- Concluding as to whether the AO is satisfied or not regarding the correctness of the taxpayer's claim about the expenditure in relation to exempt income, the AO must decide whether the presumption ought to be raised or not. If the AO finds that the presumption ought to be raised then he/she must raise it before being satisfied or not regarding the correctness of the taxpayer's claim.
- In the present case, the High Court left the question open as to whether such a presumption is valid and if valid whether it arises, and the AO must determine the same.
- If the AO justifiably is not satisfied with the correctness of the taxpayer's claim regarding the expenditure, he/she must resort to Rule 8D entirely for the determination of the expenditure incurred with respect to the exempt income for the purpose of Section 14A.

Presumption of earning exempt income by investing own funds

- The application of Rule 8D does not preclude a taxpayer from contending that he/she has not incurred any expenditure towards interest to earn the exempt income.
- Rule 8D(2) provides that the expenditure in relation to income which does not form part of the total income shall be the aggregate of the three amounts mentioned in clauses (i) (ii) and (iii) thereof. The AO must while applying Rule 8D compute each part of it. Rule 8D is applicable whether the amount computed in respect of any part of it is nil or not.
- If a taxpayer establishes that its interest free funds were equal to or more than the interest bearing funds, it would be open to it to contend that presumption arises that the expenditure for earning exempt income was incurred from out of its interest free funds. This was concluded both on principle and authority in the case of Max India Ltd.¹⁰

Our comments

Disallowance of expenditure relatable to earning of exempt income under Section 14A and the quantification of the same under Rule 8D has been a matter of debate before the Courts/Tribunal.

The Bangalore Tribunal in the case of Subramanya Constructions & Development Co. Ltd.¹¹, *inter alia*, held that the AO is not justified in invoking Rule 8D(2)(iii) for disallowance of indirect expenditure unless he/she has recorded his/her dissatisfaction of the claim, with cogent reasons. In the present case, the High Court held that the AO concluded that the taxpayer had deployed sufficient staff/officers to handle its investment portfolio for which it would have incurred substantial expenditure for various operations, and therefore, the AO has disclosed cogent reasons for invoking Rule 8D.

¹⁰ CIT v. Max India Ltd. TS-498-HC-2016(P&H)

¹¹ DCIT vs Subramanya Constructions & Development Co.Ltd. [TS-100-ITAT-2015 (Bang)]

As per the earlier Rule 8D, if a taxpayer has incurred expenditure by way of interest, other than the amount of interest already included in Rule 8D(2)(i), during the previous year which is not directly attributable to any particular income or receipt, an amount computed as specified was to be disallowed. As per the amendment¹² in Rule 8D, the scope of Rule 8D has been reduced such that the interest indirectly attributable to tax-exempt income shall not be disallowed.



¹² Notification No. 43/2016 [F.No. 370142/7/2016-TPL] with effect from 2 June 2016

Ahmedabad

Commerce House V, 9th Floor,
902 & 903, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200
Fax: +91 79 4040 2244

Bengaluru

Maruthi Info-Tech Centre
11-12/1, Inner Ring Road
Koramangala, Bangalore 560 071
Tel: +91 80 3980 6000
Fax: +91 80 3980 6999

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh 160 009
Tel: +91 172 393 5777/781
Fax: +91 172 393 5780

Chennai

No.10, Mahatma Gandhi Road
Nungambakkam
Chennai 600 034
Tel: +91 44 3914 5000
Fax: +91 44 3914 5999

Delhi

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurgaon, Haryana 122 002
Tel: +91 124 307 4000
Fax: +91 124 254 9101

Hyderabad

8-2-618/2
Reliance Humsafar, 4th Floor
Road No.11, Banjara Hills
Hyderabad 500 034
Tel: +91 40 3046 5000
Fax: +91 40 3046 5299

Kochi

Syama Business Center
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682019
Tel: +91 484 302 7000
Fax: +91 484 302 7001

Kolkata

Unit No. 603 – 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata 700 091
Tel: +91 33 44034000
Fax: +91 33 44034199

Mumbai

Lodha Excelus, Apollo Mills
N. M. Joshi Marg
Mahalaxmi, Mumbai 400 011
Tel: +91 22 3989 6000
Fax: +91 22 3983 6000

Noida

6th Floor, Tower A
Advant Navis Business Park
Plot No. 07, Sector 142
Noida Express Way
Noida 201 305
Tel: +91 0120 386 8000
Fax: +91 0120 386 8999

Pune

703, Godrej Castlemaine
Bund Garden
Pune 411 001
Tel: +91 20 3050 4000
Fax: +91 20 3050 4010

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