



## Disallowance under Section 14A is justified since the tax officer has followed the prescribed procedure

Recently, the Madras High Court in the case of Tamilnadu Industrial Development Corporation Limited<sup>1</sup> (the taxpayer) dealt with an issue of disallowance under Section 14A of the Income-tax Act, 1961 (the Act) read with Rule 8D of the Income-tax Rules, 1962. The High Court held that the findings recorded by the Assessing Officer (AO) was sufficient and a clear indication of his compliance of the procedure laid down under Section 14A(2)<sup>2</sup>. At the first instance, the AO had considered the claim of the taxpayer and since he was not satisfied with the claim he had determined the amount of expenditure under Rule 8D. Therefore, there was no failure on the part of AO to follow the procedure laid down under Section 14A(2).

### Facts of the case

The taxpayer is a state-owned undertaking, filed its return of the income for the Assessment Year (AY) 2011-12 and 2012-13. During the AY 2011-12, the taxpayer received dividend income which was claimed as exempt from tax. The AO made a disallowance under Section 14A by applying Rule 8D. The Commissioner of Income-tax (Appeals) upheld the order of AO.

For AY 2011-12, the Tribunal held that the AO straightaway proceeded to apply Rule 8D for the purpose of disallowance under Section 14A without specifying or complying with the mandatory requirement of Section 14A(2) or Rule 8D(1). The Tribunal held that the AO having failed to comply with the statutory requirement, he cannot proceed to make the disallowance under Section 14A(1).

For the AY 2012-13, the Tribunal held that the AO had not called for any specific explanation with regard to the fresh investment which were also capable of earning dividend income. Considering these facts, the Tribunal directed the taxpayer to work out the expenditure component towards administrative and managerial aspect, so that the same shall be disallowed in the computation of income of the taxpayer. Accordingly, the appeal filed by the taxpayer was partly allowed.

### High Court's decision

The principle underlying Section 14A and the procedure therein was concisely explained by the Bombay High Court in the case of Godrej & Boyce Manufacturing Company Limited<sup>3</sup>. Under Section 14A(2), the AO is required to determine the amount of expenditure incurred by the taxpayer in relation to such income, which does not form part of the total income under the Act in accordance with such method as may be prescribed. Such requirement arises if the AO is not satisfied with the correctness of the claim of the taxpayer in respect of the expenditure which the taxpayer claims to have incurred in relation to income which does not form part of the total income.

Further, the satisfaction of the AO has to be arrived at, having regard to the accounts of the taxpayer. Section 14A(2) does not enable the AO to apply the method prescribed by the rules straightaway without considering whether the claim made by the taxpayer is correct. Therefore, at the first instance, the AO has to determine whether the claim of the taxpayer is correct and the determination must be made having regard to the accounts of the taxpayer. The satisfaction of the AO must be arrived at on an objective basis and it is only when the AO is not satisfied with the claim of the

<sup>1</sup> CIT v. Tamilnadu Industrial Development Corporation Limited – [TCA Nos. 509 & 510 Of 2018]- Taxsutra.com

<sup>2</sup> AO shall determine the amount of expenditure incurred in relation to such income which does not form part of the total income under this Act in accordance with such method as may be prescribed, if the AO, having regard to the accounts of the assessee, is not satisfied with the correctness of the claim of the assessee in respect of such expenditure in relation to income which does not form part of the total income under this Act

<sup>3</sup> Godrej & Boyce Manufacturing Company Limited v. DCIT [2010] 328 ITR 81 (Bom)

taxpayer, that the legislature directs him to follow the method that may be prescribed. Therefore, it was important to check whether for AY 2011-12 such procedure was followed by the AO.

Notice was issued to the taxpayer to file the working sheet under Rule 8D for disallowance under Section 14A. The taxpayer in response to such notice, submitted a letter giving such working. The AO after going through the submission observed that the taxpayer had computed the disallowance of dividend by invoking provisions of Rule 8D. However, while doing so, ignored Rule 8D(iii). It appeared that this was pointed out to the taxpayer. However, the taxpayer though filed a response, the AO stated that the taxpayer did not address the issue of computation of the third limb of Rule 8D.

The finding recorded by the AO is sufficient and a clear indication of his compliance of the procedure under Section 14A(2). The AO at the first instance considered whether the claim of the taxpayer was correct and thereafter only had proceeded to determine the amount by adopting the procedure under Rule 8D. For AY 2011-12, there was no failure in following the procedure under Section 14A(2). The Tribunal had committed an error in not only allowing the appeal of the taxpayer on the said ground, but also by directing the AO to accept the figure mentioned by the taxpayer in their returns.

For AY 2012-13, the High Court observed that though the Tribunal had directed the taxpayer to work out the expenditure component towards administrative and managerial aspect so that the same shall be disallowed in the computation of income, it did not issue any specific directions to the AO as to what has to be done after the taxpayer files the working sheet. Therefore, to that extent the Tribunal had committed an error. Accordingly, the High Court remanded the matter back to the AO for fresh consideration in accordance with the law.

## Our comments

The issue with respect to disallowance of expenditure under Section 14A read with Rule 8D has been a subject matter of debate before the Courts/Tribunal.

The Supreme Court in the case of Maxopp Investment Ltd.<sup>4</sup> held that the language of Section 14A(2) makes it clear that before applying the theory of apportionment, the AO needs to record its satisfaction that having regard to the accounts of the taxpayer, the *suo motu* disallowance made by the taxpayer under Section 14A was not correct. The AO cannot reject *suo-motu* disallowance made by the taxpayer under Section 14A without recording his satisfaction as required under Section 14A(2).

<sup>4</sup> Maxopp Investment Ltd. v. CIT [2018] 402 ITR 640 (SC), ACIT v. Indiabulls Real Estate Ltd (ITA No. 6602/Del/2016, 11 March 2020), Punjab Tractors Ltd. v. CIT [2017] 393 ITR 223 (P&H), PCIT v. U. K. Paints (India) (P.) Ltd. [2017] 392 ITR 552 (Del)

However, the Courts in some of the cases<sup>5</sup> while scrutinising the provisions of Section 14A held that where the AO had carried out an elaborate analysis and had thereafter followed the steps enacted in the statute in determining the amount of expenditure incurred for earning tax exempt income, the fact that he did not record his dissatisfaction about taxpayer's calculation of disallowance, could not be a ground for rejection of the stand taken by the AO.

The High Court in the present case has held that the finding recorded by the AO is sufficient and a clear indication of his compliance of the procedure under Section 14A(2). The AO at the first instance has considered whether the claim of the taxpayer was correct and thereafter only had proceeded to determine the amount by adopting Rule 8D. Therefore, there was no failure in following the procedure laid down under Section 14A(2) .



<sup>5</sup> Indiabulls Financial Services Ltd. v. DCIT [2016] 76 taxmann.com 268 (De), Devarsons Industries (P.) Ltd. v. ACIT [2017] 84 taxmann.com 244 (Guj)

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