

TAX FLASH NEWS

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No disallowance under Section 14A where investments are made out of common funds and interest-free funds are higher than the amount invested in tax-free securities

Recently, the Supreme Court in the case of South India Bank Ltd¹ (the taxpayer) has dealt with the issue of disallowance of proportionate interest expenditure where tax-free investments are made out of mixed funds (partly of interest-free funds and partly of interest-bearing funds). The Supreme Court has held that disallowance of expenditure incurred in relation to exempt income is not attracted where the tax-free investments are made from mixed funds and the interest-free funds of the taxpayer are higher than the amount of tax-free investment.

The Supreme Court also advised the government that there is no room for presumptions in taxation and that government should keep the taxation regime simple and convenient for taxpayers to achieve maximum compliance. If the government aims to curb tax avoidance, it has the responsibility to design a tax regime for which a taxpayer can budget and plan taxes. This avoids unnecessary litigation without compromising generation of revenue.

Facts of the case

The taxpayer, a scheduled bank, had made investment in bonds, securities and shares in course of normal banking business. It earned exempt income in the form of interest and dividend. The taxpayer had not maintained any separate accounts for tax-free investments and investments which gave rise to taxable income.

In absence of separate accounts for investment which earned tax free income, the Assessing Officer (AO) made proportionate disallowance of interest attributable to the funds invested to earn tax free income. The Commissioner of Income-tax (Appeals) [CIT(A)] concurred with the view taken by the AO.

The Tribunal observed that the taxpayer bank was having indivisible business and considering their nature of business, the investments made in tax free bonds and in shares would therefore be in nature of stock in trade. The Tribunal observed that the taxpayer bank is having surplus funds and reserves from which investments can be made. Accordingly, it accepted the taxpayer's case that investments were not made out of interest or cost bearing funds alone. Thus it was held that disallowance under Section 14A was not warranted, in absence of clear identity of funds.

However, the Kerala High Court reversed the order of the Tribunal. Aggrieved, the taxpayer filed an appeal before the Supreme Court.

Supreme Court decision

Investment from mixed funds

In a situation where the taxpayer has mixed fund and the payment is made out of that mixed fund, the investment must be considered to have been made out of the interest free fund. The taxpayer has such right of appropriation and also the right to assert from what part of the fund a particular investment is made, and it may not be permissible for the Revenue to make an estimation of a proportionate figure.

For accepting such a proposition, the Supreme Court referred the decision of the Bombay High Court in the case of Bombay Dyeing and Mfg. Co. Ltd², Reliance Industries Ltd³ and various other decisions⁴. The High Courts have correctly interpreted the scope of Section 14A in their decisions favoring the taxpayer.

² Pr. CIT v. Bombay Dyeing and Mfg.Co. Ltd (ITA No. 1225 of 2015) (The resultant SLP of the tax department challenging the Bombay High Court judgment was dismissed both on merit and on delay by the Supreme Court.

³ CIT (Large Tax Payer Unit) v. Reliance Industries Ltd [2019] 410 ITR 466 (SC)

⁴ HDFC Bank Ltd. v. DCIT [2016] 383 ITR 529 (Bom), CIT v. Suzlon Energy Ltd [2013] 354 ITR 630 (Guj), CIT v. Microlabs Ltd. [2016] 383 ITR 490 (Kar) and CIT v. Max India Ltd [2016] 388 ITR 81 (P & H)

¹ South India Bank Ltd v. CIT [2021] 130 taxmann.com 178 (SC)

If investments in Securities is made out of common funds and the taxpayer has available, non-interest-bearing funds larger than the investments made in tax-free securities then in such cases, disallowance under Section 14A cannot be made.

The Supreme Court distinguished the decision relied on by the tax department in the case of S.A Builders⁵ whose correctness has been doubted in the subsequent Supreme Court decision in the case of Tulip Star Hotels Ltd.⁶ and, hence, referred to the Larger Bench. In that case, loans were extended to sister concern while in the present case, the taxpayer banks had invested in bonds/securities. The factual scenario was different and distinguishable and therefore the issue pending before the larger Bench should have no bearing at this stage for the present matters.

Separate books of accounts not required

The Kerala High Court in the taxpayer's case endorsed the proportionate disallowance made by the AO under Section 14A to the extent of investments made in tax-free bonds/securities primarily because separate account was not maintained by taxpayer. However, the Supreme Court distinguished its earlier decision in the case of Honda Siel Power Products Ltd.⁷ relied by the tax department. The said case dealt with taxpayer's responsibility to fully disclose all material facts in relation to expenditure incurred for earning exempt income in the course of assessment proceedings to preclude initiation of reassessment. The decision was not an authority for legal obligation on the taxpayer to maintain separate books of accounts for tax-free income.

In the absence of any statutory provision which compels the taxpayer to maintain separate accounts for different types of funds, the decision cited by the tax department will have no application to support the tax department's contention against the taxpayer.

Reference to earlier Supreme Court cases

Reference was made to the decision of Maxopp Investments Ltd.⁸ wherein it was held that disallowance cannot be made in respect of tax-free investments held as stock-in-trade since such investment is made to earn taxable business profits from trading and not to earn exempt dividend income which is received by quirk of fate of holding the shares on the date of declaration of dividend. Similarly, the Supreme Court in the case of Godrej & Boyce Manufacturing Co Ltd.⁹ held that where

taxpayer claims investment to be made from interest-free funds, it is necessary for the tax authority to establish that expenditure is incurred in earning of exempt income.

CBDT Circular No. 18/2015

Reference was made to CBDT Circular¹⁰ which had explained that all shares and securities held by a bank which are not bought to maintain Statutory Liquidity Ratio (SLR) are its stock-in-trade and not investments and income arising out of those is attributable, to business of banking.

The Circular was issued after the decision of Nawanshahar Central Cooperative Bank Ltd¹¹ wherein this Court had held that investments made by a banking concern is a part of their banking business. Hence the income earned through such investments would fall under the head 'Profits & Gains of business or profession'.

The Supreme Court held that, since there was no fact found by the tax authority that the investments were made for complying with SLR, the tax-free investments made had to be considered as giving rise to taxable business income from trading.

Requirement of simplification of taxation regime to achieve compliance

The Supreme Court observed that in taxation regime, there is no room for presumption, and nothing can be taken to be implied. The tax an individual or a corporate is required to pay, is a matter of planning for a taxpayer and the government should endeavour to keep it convenient and simple to achieve maximization of compliance. Just as the government does not wish for avoidance of tax, it is the responsibility of the regime to design a tax system for which a subject can budget and plan. If proper balance is achieved between these, unnecessary litigation can be avoided without compromising on generation of revenue.

Our comments

The Supreme Court put to rest the controversy of disallowance under Section 14A where tax free investments are made out of mixed funds available with the taxpayer. The Supreme Court held that where the taxpayer has mixed fund, the investment must be considered to have been made out of the interest free fund. Thus, so long as interest-free funds are more than tax-free investments, interest expenditure cannot be allocated to tax-free income.

⁵ S.A Builders v. CIT [(2007) 1 SCC 781]

⁶ Addl CIT v. Tulip Star Hotels Ltd. (SLP (C) No. 14729 of 2012)

⁷ Honda Siel Power Products Ltd. v. DCIT [(2012) 12 SCC 762]

⁸ Maxopp Investments Ltd. v. CIT [2018] 402 ITR 640 (SC)

⁹ Godrej & Boyce Manufacturing Co Ltd. v. DCIT [2017] (7 SCC 421)

¹⁰ Circular No. 18 of 2015, dated 2 November 2015

¹¹ CIT v. Nawanshahar Central Cooperative Bank Ltd. [2007] 16 Taxman 48 (SC)

The Supreme Court emphasised that the absence of maintenance of separate accounts for earning tax-free income does not lead to disallowance of expenditure under Section 14A.

It is important to note that from FY 2020-21 onwards, the provisions of taxation of dividend in the hands of the shareholders have been re-introduced. Since dividend is no more an exempt income, disallowance under Section 14A would not be attracted vis-à-vis expenditure incurred towards earning such income.



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