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ISSUES IN SECTION 14A AND SECTION 56 OF THE INCOME TAX ACT, 1961

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A. Section 14A of the Act:–

(1) Expenditure incurred in relation to income not includible in total income

The provision of section 14A of the Income Tax Act, 1961 [hereinafter referred to as 'of the Act'] was inserted by the Finance Act, 2001 with retrospective effect from 01.04.1962. The provision of section 14A of the Act is read as under:

(1) For the purposes of computing the total income under this chapter, 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 this Act:

Provided that nothing contained in this section shall empower the Assessing Officer either to reassess under section 147 or pass an order enhancing the assessment or reducing a refund already made or otherwise increasing the liability of the assessee under section 154, for any assessment year beginning on or before the 1st day of April, 2001.

(2) The Assessing Officer 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 Assessing Officer, 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.

(3) The provisions of sub-section (2) shall also apply in relation to a case where an assessee claims that no expenditure has been incurred by him in relation to income which does not form part of the total income under this Act.

(2) Rule 8D - Method for determining amount of expenditure in relation to income not includible in total income

(1) Where the Assessing Officer, having regard to the accounts of the assessee of a previous year, is not satisfied with –

(a) the correctness of the claim of expenditure made by the assessee; or

(b) the claim made by the assessee that no expenditure has been incurred, in relation to income which does not form part of the total income under the Act for such previous year, he shall determine the amount of expenditure in relation to such income in accordance with the provisions of sub-rule (2).

(2) The expenditure in relation to income which does not form part of the total income shall be the aggregate of following amounts, namely:-

(i) the amount of expenditure directly relating to income which does not form part of total income;

(ii) in a case where the assessee has incurred expenditure by way of interest during the previous year which is not directly attributable to any particular income or receipt, an amount computed in accordance with the following formula, namely:-

$$A \times \frac{B}{C}$$

Where **A** = amount of expenditure by way of interest other than the amount of interest included in clause (*i*) incurred during the previous year;

B = the average of value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

C = the average of total assets as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year;

(*iii*) an amount equal to one-half per cent of the average of the value of investment, income from which does not or shall not form part of the total income, as appearing in the balance sheet of the assessee, on the first day and the last day of the previous year.

(2) For the purposes of this rule, the "total assets" shall mean, total assets as appearing in the balance sheet excluding the increase on account of revaluation of assets but including the decrease on account of revaluation of assets.

(3) <u>Case laws:-</u>

(1) CIT vs. Indian Bank Ltd [1965] 56 ITR 77 (SC)

Facts:

The assessee carried on the business of banking. In the normal course of its business, it received deposits from constituents and paid interest to them. It invested a large sum in securities both of the Central and State Governments. The interest on Mysore Government securities was exempt from income-tax and super-tax the provisions of a notification issued under section 60 of the Act. It bought and sold these securities and the profits and losses on the purchase and sale of such securities were duly taken into account in computing the income of the assessee, under the

head "business". The assessee claimed a deduction of interest paid to various depositors, under section 10(2)(iii) of the 1922 Act. The ITO, the AAC and the Tribunal disallowed the proportionate interest which would be payable on money borrowed for the purchase of Mysore securities.

Held:

In section 10(2)(xv), of the 1922 Act what Parliament requires to be ascertained is whether the expenditure has been laid out or expended wholly and exclusively for the purpose of the business. The legislature stops short at directing that it be ascertained what was the purpose of the expenditure. If the answer is that it is for the purpose of the business, Parliament is not concerned to find out whether the expenditure has produced or will produce taxable income. Secondly, the reason may well be that Parliament assumes that most types of expenditure which are laid out wholly and exclusively for the purpose of business would directly or indirectly produce taxable income, and it is not worth the administrative effort involved to go further and trace the expenditure to some taxable income.

Therefore, it seems that there is nothing in the language of section 10 of the 1922 Act, from which it can be fairly implied that an expenditure or allowance falling within the section must fulfill some other condition before it can be allowed.

(2) Position before and after the order passed by Hon'ble Hon'ble Bombay High Court in the case of Godrej & Boyce Mfg. Co. Ltd. vs. DCIT [2010] 328 ITR 81 (Bombay)

(3) CIT vs. Hero Cycles Ltd. [2009] 323 ITR 518 (P&H)

Disallowance under Section 14A required finding of incurring of expenditure where it is found that for earning exempted income no expenditure has been incurred, disallowance under Section 14A cannot stand.

Affirmed by apex court in

(4) CIT vs. Walfort Share and Stock Brokers Pvt. Ltd. [2009] 310 ITR 421 (Bom.)

What section 14A contemplates is the expenditure actually incurred for earning tax free income and not assumed expenditure or deemed expenditure. In these circumstances, the decision of the Tribunal in rejecting the alternate argument of the Revenue cannot be faulted.

The view of Hon'ble Bombay High Court has been upheld by apex court in CIT vs. Walfort Share and Stock Brokers Pvt. Ltd. [2010] 326 ITR 1 (SC).

(5) Yogesh J. Shah vs. ACIT [2011] 46 SOT 183 (Mumbai)(URO)

The requirement for invoking the provisions of section 14A is that an expenditure is actually incurred for the activity which resulted or may result the income not forming part of total income of the assessee. Merely invoking the provisions of section 14A does not ipso facto disallow the expenditure when no expenditure has been incurred for earning the exempt income rather the provisions of section 14A provides procedure for inquiry and verification to find out whether any expenditure is incurred by the assessee in relation to the income which is exempt, and does not form the part of the total income.

(6) CIT vs. HDFC Bank Ltd [2014] 366 ITR 505 (Bombay)

No disallowance under section 14A can be made out of interest expenditure when no part of the interest bearing fund has been used for making investment in shares on which dividend has been earned.

(7) Joint investments (Pvt.) Ltd vs. CIT [2015] 372 ITR 694 (Delhi)

By no stretch of imagination can s. 14A or r. 8D be interpreted so as to mean that the entire tax exempt income is to be disallowed.

(8) ACIT vs. Novel Enterprises [2012] 52 SOT 127 (Mumbai)

Assessee had utilized interest bearing funds for making loan/capital contribution to a Partnership Firm in which it was a partner. It had received interest income and share in profits from the said Partnership Firm. AO was of the view that interest expenditure incurred by assessee had resulted in taxable as well as tax free income and hence, that portion of interest which related to share of profit was liable to be disallowed u/s 14A for A.Y.2005-06. The Appellate Tribunal held that Indian Partnership Act, 1932 does not contemplate or stipulate capital contribution by the partner as one of the conditions for a partnership firm. Sharing of profit/loss is the only condition (S.4 of P Act). Therefore, it cannot be said that contribution in the capital of the Partnership Firm has resulted into share of profit in the hands of the assessee. Therefore no disallowance is called for u/s 14A of the Act.

(9) CCI Ltd vs. JCIT [2012] 250 CTR 291 (Karnataka)

Fact:-

Assessee was a dealer in shares and securities. It had purchased shares of a company by availing an interest free loan and had paid certain amount for brokering the same. 63% of said shares were sold and income derived thereon was offered to tax as business income. Remaining 37% shares remained unsold on which the assessee earned dividend income. A.O. held that the brokerage expenditure was directly attributable to the earning of dividend income and disallowed the same. On appeal, CIT(A) confirmed the order passed by A.O. On further appeal, the Appellate Tribunal held

that the expenditure which was relatable to earning of dividend income, though incidental to trading of shares, was to be disallowed u/s 14A. However, Hon'ble ITAT found that entire expenditure was not relatable to dividend income only as the loan was utilized for purchase of shares and profit earned on sale of certain shares out of those shares (i.e. 63% shares) had been offered as business income. Hence, the Appellate Tribunal directed the A.O. to bifurcate all the expenditure proportionately and allow the expenditure in accordance with law. The department being aggrieved challenged the other before the Hon'ble High Court. The Hon'ble court has held that when no expenditure is incurred in earning dividend income, no notional expenditure could be deducted from the said income. Where dividend income is incidental to assessee's business of sale of shares which remained unsold by it, expenditure incurred in acquiring shares cannot be apportioned to extent of dividend income for making disallowance under section 14A.

Also DCIT vs. M/s. India Advantage ITA 6711/Mum/2011 dated 14.09.2012 uphled by Hon'ble Bombay High Court in ITXA 1131 of 2013 dated 13.04.2015

(10) CIT vs. Oriental Structural Engineers Pvt. Ltd in [2013] 216 Taxman 92 (Delhi)(MAG.)

No disallowance under section 14A of the Act can be made on investment made in subsidiary company out of commercial expediency.

(11) M/s. J.M. Financial Ltd vs. ACIT in ITA No. 4521/Mum/2010 for A.Y. 2009-10 order dated 26.03.2014 wherein the Appellate Tribunal has held that provisions of section 14A is not applicable to strategic investment made in subsidiary company.

(12) Cheminvest Ltd vs. CIT [2015] 378 ITR 33 (Delhi)
Section 14A will not apply if no exempt income is received during the relevant previous year.
Same view in CIT vs. Shivam Motors (P.) Ltd [2014] 272 ITR 277 (All)
CIT vs. Lakhani Marketing Inc. [2014] 272 CTR 265 (P&H)

(13) ACIT vs. Champion Commercial co. [2012] 139 ITD 108 (Kol.)
Correct application of formula set out in rule 8D(2)(ii) is that interest expenses directly attributable to tax exempt income as also directly attributable to taxable income are to be exclude from computation of common interest expenses.

(14) ACIT vs. Best & Crompton Engineering Ltd. [2013] 60 SOT 53 (Chennai - Trib.)(URO);
Bank interest and interest on term loan sanctioned for business projects do not form part of calculation of disallowance under section 14A

(15) Rei Agro Ltd vs. DCIT [2013] 144 ITD 141 (Kolkata - Trib.)
Disallowance under rule 8D with respect to income not includible in total income cannot be computed by taking into consideration entire value of investment from which such income has been earned

B. <u>ISSUES UNDER SECTION 56 OF THE ACT:</u>

<u>Income from other sources section 56 of the Income Tax Act, 1961</u>.

(1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head “Income from other sources”, if it is not chargeable to income-tax under any of the heads specified in section 14, items A to E. [

(A) Salaries, (B) Interest on securities omitted w.e.f. 1-4-1989, (C) Income from house property, (D) Profit and Gains from Business and Profession and (E) Capital gains]. Under section 56(1) income of every kind which is not to be excluded from the total income shall be chargeable to income-tax. The emphasis is on that income of every kind. To tax Any amount under this section, it must have some character of income

(2) Section 56(2) lists incomes chargeable to income tax under the head 'Income from Other Sources' as under:

(i) Dividends

(ia) Omitted by Finance Act 1988 w.e.f. 01.04.1988

(ib) income referred to in sub-clause (ix) of clause (24) of section 2 (Section 2 (24)(ix):- any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever. Such winnings are chargeable to tax at the rate of 30% under section 115BB of the Act.

(ic) income referred to in sub-clause (x) of clause (24) of section 2, if such income is not chargeable to income-tax under the head "Profits and gains of business or profession". (Section 2 (24)(x):- any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or contributions to any provident fund or superannuation fund or any fund set up under the provisions of the Employees' State Insurance Act, 1948 (34 of 1948), or any other fund for the welfare of such employees)

(id) income by way of interest on securities, if the income is not chargeable to income-tax under the head "Profits and gains of business or profession".

(ii) income from machinery, plant or furniture belonging to the assessee and let on hire, if the income is not chargeable to income-tax under the head “Profits and gains of business org profession”.

(iii) where an assessee lets on hire machinery, plant or furniture belonging to him and also buildings, and the letting of the buildings is inseparable from the letting of the said machinery, plant or furniture, the income from such letting, if it is not chargeable to income-tax under the head “Profits and gains of business or profession”.

(iv) income referred to in sub-clause (xi) of clause (24) of section 2, if such income is not chargeable to income-tax under the head "Profits and gains of business or profession" or under the head "Salaries”. (Section 2 (24)(xi) “any sum received under a KIP including the sum allocated by way of bonus on such policy allocated by way of bonus on such policy. Explanation.—For the purposes of this clause, the expression "Keyman insurance policy" shall have the same meaning assigned to it in the Explanation to section meaning assigned to it in the Explanation to section 10(10D)”)

(v) where any sum of money exceeding twenty-five thousand rupees is received without consideration by an individual or a Hindu undivided family from any person on or after the 1st day of September, 2004 but before the 1st day of April, 2006, the whole of such sum:

Provided that this clause shall not apply to any sum of money received—

(a) from any relative; or

(b) on the occasion of the marriage of the individual; or

(c) under a will or by way of inheritance; or

(d) in contemplation of death of the payer; or

(e) from any local authority as defined in the Explanation to clause (20) of section 10; or

(f) from any fund or foundation or university or other educational institution or hospital or other medical institution or any trust or institution referred to in clause (23C) of section 10; or

(g) from any trust or institution registered under section 12AA.

(vi) where any sum of money, the aggregate value of which exceeds fifty thousand rupees, is received without consideration, by an individual or a Hindu undivided family, in any previous year from any person or persons on or after the 1st day of April, 2006 but before the 1st day of October, 2009, the whole of the aggregate value of such sum:

(vii) where an individual or a Hindu undivided family receives, in any previous year, from any person or persons on or after the 1st day of October, 2009,—

(a) any sum of money, without consideration, the aggregate value of which exceeds fifty thousand rupees, the whole of the aggregate value of such sum;

(b) any immovable property,—

(i) without consideration, the stamp duty value of which exceeds fifty thousand rupees, the stamp duty value of such property;

(ii) for a consideration which is less than the stamp duty value of the property by an amount exceeding fifty thousand rupees, the stamp duty value of such property as exceeds such consideration:

Provided that where the date of the agreement fixing the amount of consideration for the transfer of immovable property and the date of registration are not the same, the stamp duty value on the date of the agreement may be taken for the purposes of this sub-clause:

Provided further that the said proviso shall apply only in a case where the amount of consideration referred to therein, or a part thereof, has been paid by any mode other than cash on or before

the date of the agreement for the transfer of such immovable property;

(c) any property, other than immovable property,—

(i) without consideration, the aggregate fair market value of which exceeds fifty thousand rupees, the whole of the aggregate fair market value of such property;

(ii) for a consideration which is less than the aggregate fair market value of the property by an amount exceeding fifty thousand rupees, the aggregate fair market value of such property as exceeds such consideration :

Provided that where the stamp duty value of immovable property as referred to in sub-clause (b) is disputed by the assessee on grounds mentioned in sub-section (2) of section 50C, the Assessing Officer may refer the valuation of such property to a Valuation Officer, and the provisions of section 50C and sub-section (15) of section 155 shall, as far as may be, apply in relation to the stamp duty value of such property for the purpose of sub-clause (b) as they apply for valuation of capital asset under those sections :

(3) **Case Laws:**

(1) Sudhir Menon HUF Vs. ACIT [2014]162 TTJ 425 (Mumbai-Trib.)

Where additional shares of a company were allotted pro rata to shareholders including assessee based on their existing shareholding pattern, there was no scope for any property being received on said allotment of shares and therefore, provisions of section 56(2)(vii)(c) did not apply to difference in book value and face value of additional shares.

(2) Harshadbhai Dahyalal Vaidhya (HUF) Vs. ITO [2013] 155 TTJ 71 (Ahmedabad-Trib.)

Where assessee-HUF received a sum of Rs. seven lakh as gift from a relative of Karta of HUF, in terms of proviso to section 56(2)(v) amount so received could not be brought to tax

(3) DCIT Vs. Paras D. Gunecha [2015] 169 TTJ 1 (Mumbai-Trib.)

Where assessee received certain sum out of family settlement, same was not taxable as under section 56(2)(v)

(4) Prema J. Sanghvi [2015] ITA No. 2109/Mum/2011 (Mumbai-Trib)

Alimony received by the assessee from her ex-husband is not taxable under the head "Income from other sources" and the same is non-taxable capital receipt.

(5) DCIT vs. Paras D. Gundecha [2015] 155 ITD 880 (Mumbai - Trib.)

Where assessee received certain sum out of family settlement, same was not taxable as under section 56(2)(v).