

WHITE PAPER

DISALLOWANCE UNDER SECTION 14A - EXPENDITURE IN RESPECT OF EXEMPT INCOME & RECENT AMENDMENT TO RULE 8D

1.0 BACKGROUND

- 1.1 Recently, the Central Board of Direct Taxes (CBDT) vide official gazette dated 2 June 2016 notified the amendment made to Rule 8D of the Income Tax Rules 1962 (IT Rules). One of the most litigative issues in direct taxation faced by business entities pertains to disallowances made under **section 14A** of the Income Tax Act 1961 (IT Act) read with **Rule 8D** of the IT Rules. As per the Income Tax simplification Committee headed by Justice R.V. Easwar which issued its report in January 2016, it noted that around 15% of the tax litigation is attributed to determination of expenditure relating to exempt income.
- 1.2 Under the provisions of said section 14A, the expenditure incurred in relation to exempt income is to be disallowed while computing the total income. From Assessment Year (AY) 2008-09² and onwards, this disallowance of such expenditure is made following the mechanism as prescribed in Rule 8D of the IT Rules.
- 1.3 **Amended Rule 8D applicable from Financial Year 2016-17 (Assessment Year 2017-18)**

The amendment brought in Rule 8D is applicable from the date of its notification in the official gazette i.e. 2nd June 2016 and as such shall be applicable from the financial year 2016-17 and onwards.

2.0 BACKGROUND OF SECTION 14A OF THE ACT – EXPENDITURE INCURRED IN RELATION TO INCOME NOT INCLUDIBLE IN TOTAL INCOME

- 2.1 The provisions of section 14A were enacted by the Finance Act, 2001 by retrospective effect, w.e.f. 1.4.1962. The section reads as under:

"For the purpose 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 total income under the Act."

² In *Godrej & Boyce Mfg. Co. Ltd. v. Dy. CIT* [2010] 194 Taxman 203 (Bom.), the Court upheld the vires of Rule 8D and held it to be prospective in application with effect from assessment year 2008-09

2.2 The expenses incurred can be allowed only to the extent that they are relatable to earning of the taxable income and expenses relatable to exempted income are to be disallowed. Thus, section 14A of the IT Act uses the expression “in relation to” and “incurred”, which makes it necessary to identify exact expenditure incurred to earn the exempt income. As such, unless expenditure has been actually incurred by the assessee in respect of earning the exempt income, the same is not subject to disallowance under section 14A of the IT Act. Further, the onus is cast on the Assessing Officer (AO), who has to record satisfaction on perusal of the accounts of the assessee, about the correctness of claim of the assessee of such expenditure being in relation to taxable income. If the AO is not satisfied, then the provisions of computation mechanism as provided in Rule 8D of the IT Rules for such disallowance shall need to be applied.

2.3 The amendment made in Rule 8D vide notification dated 2 June 2016 is discussed hereunder.

3.0 COMPARATIVE MATRIX OF DISALLOWANCE PROVISION UNDER SECTION 14A (EARLIER RULE 8D VIS-À-VIS AMENDED RULE 8D)

3.1 The following table provides an overview of the changes proposed by the amended Rule 8D, the effective date of which shall be date of its notification in the official Gazette (i.e. 2nd June 2016).

Limb of Rule 8D(2)	Earlier Rule 8D coverage	Amended Rule 8D Coverage	Remarks
(i)	Direct expenditure relating to income which does not form part of total income	Direct expenditure relating to income which does not form part of total income	✓ No Change in this sub-rule
(ii)	Indirect Expenditure - Interest not directly attributable to any particular income or receipt <u>Computation Mechanism</u> (Interest Expenditure X Average value of Investment, income from which is exempt [^]) / Avg	Omitted	This sub-rule was the major source of litigation (<i>illustrative list as under</i>), which has been substantially addressed. ✓ Common pool of funds - When owned funds available for investment purposes exceeded borrowed funds ✓ When no exempt income received during such year

Limb of Rule 8D(2)	Earlier Rule 8D coverage	Amended Rule 8D Coverage	Remarks
	<p>value of Total Assets^{3^}</p> <p><i>^average on the on the first day and the last day of the relevant financial year</i></p>		<p>✓ When the interest disallowance exceeded the amount debited to the Profit & Loss Account</p>
(iii)	<p>0.5% X Average value of Investment[^] (income from which is exempt)</p> <p><i>^average on the on the first day and the last day of the previous year</i></p> <p>No Such Limit</p>	<p><u>Limb (iii) replaced by Limb (ii) and earlier limb (ii) omitted</u></p> <p><u>1% X Average value of Investment^^ (income from which is exempt)</u></p> <p><u>^^ annual average of the monthly averages of the opening and closing balances of the value of investment</u></p> <p>There is a cap on the disallowance under rule 8D, which is restricted to the amount of total expenditure claimed by the assessee</p>	<p>Increase in the rate of disallowance from 0.5% to 1% along with the change in the computation mechanism to annual average of monthly opening and closing average, may lead to higher disallowance in business entities having a large portfolio of investment assets and increased documentation for computing Rule 8D disallowance.</p> <p>Earlier there was no limit on the disallowance as per Rule 8D and would be particularly relevant for entities primarily having investment activity.</p>

4.0 RECOMMENDATION OF THE INCOME TAX SIMPLIFICATION COMMITTEE ('COMMITTEE') HEADED BY R.V.EASWAR – BRIEF ANALYSIS

Sr. No.	Recommendations	Remarks
1)	Dividend received after suffering dividend-distribution tax (DDT) and share of income from firm suffering tax in the firm's hands will not be	Not Considered in the newly amended Rule 8D and as such, will continue to be considered for the

³ Total Assets = “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

	treated as exempt income and no expenditure will be disallowed as relatable to them	purpose of disallowance
2)	Expenditure disallowed shall not exceed the amount claimed	This recommendation has been considered. As per the amended Rule 8D, it is provided that the disallowance shall be restricted to the amount claimed by the assessee.
3)	Recommendation for issue of executive instructions that no interest be disallowed if source of investment is directly relatable to taxable income	This recommendation has not been implemented as the entire disallowance on account of interest under sub-rule 8D(2)(ii) has been removed.

5.0 INDICATIVE IMPACT ANALYSIS – AN OVERVIEW OF POST-AMENDMENT IN RULE 8D

Sr. No.	Aspects	Relevance of Issues in (b)	Illustrative list of Case Laws / judicial precedents	Remarks / Implications
(a) 1)	<p>(b) Rule 8D not mechanically applicable – recording of satisfaction required by AO</p> <p>Under section 14A assessing officer (AO) to have a recourse to disallowance, 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</p>	(c) Still Relevant	<p>(d) In Favour of assessee:</p> <ul style="list-style-type: none"> Maxopp Investment Ltd. & Ors. v. CIT [2011] 347 ITR 272 (Del.) (HC) CIT v. Hero Management Service Ltd. [2014] 360 ITR 68 (Del.) (HC) Kodak India Pvt. Ltd. v. ACIT [2013] 155 TTJ 697 (Mum.)(Trib.) Auchtel Products Limited v. ACIT [2012] 52 SOT 39 (Mum.) (Trib.) 	<p>(e) No change in this position as no amendment made to section 14A.</p> <p>As such, it shall still be required for the AO to record his satisfaction on perusal of the accounts of the assessee before applying Rule 8D.</p> <p>Applicability of Rule 8D even for AY 2017-18 and onwards still is not direct.</p>

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			<ul style="list-style-type: none"> DCIT v. REI Agro Ltd. (Kol.)(Trib.)(www.itatonline.org)[AY 2009-10]. This decision has been upheld by the Calcutta High Court in GA 3022 of 2013 dated 23/12/2013 	
2)	<p><u>Strategic Business Investments</u></p> <p>No 14A disallowance on investment due to commercial expediency/<i>subsidiary company</i> and Investment in subsidiary and for acquiring controlling interest/strategic investment</p>	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> EIH Associated Hotels Ltd. v. DCIT (Chennai) (Trib.) CIT v. RPG Transmissions Ltd. [2014] 48 taxmann.com 57 (Mad HC) Garware Wall Ropes Ltd. v. ACIT (Mum.)(Trib.) [AY 2009-10]. Interglobe Enterprises Ltd. v. DCIT(Del.)(Trib.) [AY 2008-09 & 2009-10] CIT v. Oriental Structural Engineers (P.) Ltd. [2013] 216 Taxman 92/35 taxmann.com 210 (Delhi) Piem Hotels Limited - TS-162-ITAT-2015(Mum) 	Judgements rendered in context of strategic business investments made (such as subsidiary, etc) shall still be relevant while computing disallowance as per the amended requirement of Rule 8D(2).
3)	<p>Disallowance u/s 14A cannot exceed expenditure debited to profit and loss account</p>	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> ACIT v. Iqbal M. Chagala [Mum] 	Post amendment, the Rule 8D provides that the disallowance

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			<p>(Trib)] [ITA No. 877/Mum/2013]</p> <p>[Date of Pronouncement :30/07/2014]</p> <ul style="list-style-type: none"> Gillette Group India (P.) Ltd. v. Asstt. CIT [2012] 22 taxmann.com 61 (Delhi) 	cannot exceed total expenditure claimed by the assessee
4)	No Disallowance in absence of exempt income	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> CIT v. Cortech Energy Pvt. Ltd., TA No. 239 of 2014 (Guj.) (HC); CIT v. Lakhani Marketing, ITA No. 970/2008 (P&H)(HC); CIT v. Delite Enterprises, ITA No. 110/2009 (Bom.)(HC). CIT v. Shivam Motors (P) Ltd., ITA No. 88/2014 (All.)(HC); Chennai bench of the Tribunal in ACIT v. M. Baskaran (Chennai) (Trib.) <p><u>Against Assessee</u></p> <ul style="list-style-type: none"> Doubledot Finance Ltd. vs. DCIT [2014] 49 taxmann.com 291 (Mumbai - Trib.) Siva Industries & Holdings Ltd v. Asstt. CIT [2012] 54 SOT 	Unsettled position pursuant to issue of CBDT circular 5/2014 (dated 11 February 2014), which provides for disallowance u/s 14A r.w Rule 8D, even in case of Exempt Income

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			49/26 taxmann.com 96 (Chennai -Trib).	
5)	No disallowance on shares held as stock-in-trade	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> ▪ Paresh Pritamlal Mehta v. ITO [(Pune Trib)] ▪ HDFC Bank Ltd v. DCIT (Bom HC) [Writ Petition No.1753 of 2016] ▪ Dy. CIT v. Gulshan Investment Co. Ltd. [2013] 142 ITD 89/31 taxmann.com 113 (Kol.) [only rule 8 D(2)(i)] <p><u>Against Assessee</u></p> <ul style="list-style-type: none"> ▪ D.H. Securities (P.) Ltd. v. DCIT, (2014) 41 taxmann.com 352 (Mum Trib)(TM) ▪ DCIT v. Damani Estates & Finance Pvt. Ltd., (2014) 44 taxmann.com 385 (Mum Trib) 	If asset is classified as stock-in-trade, it may not be considered for the computation mechanism as prescribed under Rule 8D(2)(ii)
6)	Consideration of Interest expenditure net of interest income [for earlier Rule 8D(2)(ii)]	Not Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> ▪ Morgan Stanley India Securities Pvt. Ltd v. ACIT [ITA No.5072/Mum/2005 and 6774/Mum/2008] [AY 2001-02 and 2004-05] [date of order 13 April 2011] 	Not relevant as the amended Rule 8D does not provide for disallowance of indirect interest expenditure

Sr. No.	Aspects	Relevance of Issues in (b)	Illustrative list of Case Laws / judicial precedents	Remarks / Implications
			<ul style="list-style-type: none"> ▪ DCIT v. M/s Trade Apartments Ltd. [ITA No.: 1277/ Kol / 2011] [date of order 30 March 2012, AY 2008-09] ▪ Asst. Director of Income Tax v. International Nederland Bank [ITA No. 50988 and 5099/Mum/2004] [date of order 25 March 2011] 	
7)	No interest disallowance for sufficiency of own funds/ interest-free funds	Not relevant	<u>In Favour of assessee:</u> <ul style="list-style-type: none"> • CIT v. Torrent Power Ltd. [2014] 363 ITR 474 (Guj.) (HC), • DIT v. BNP Paribas SA [2013] 214Taxman 548 (Bom.) (HC), • CIT v. UTI Bank Ltd. [2013] 215 Taxman 8 (Mag.) (Guj.) (HC), • CITv. Reliance Utilities & Power Ltd. [2009] 313 ITR 340 (Mum.)(Trib.), • HDFC Bank Ltd v. DCIT (Bom HC) [Writ Petition No.1753 of 2016] • Sharekhan Financial Services (P) Ltd. v. ACIT, ITA No. 	Not relevant as the amended Rule 8D does not specifically provide for disallowance of interest expenditure

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			5861/M/2011, dated 20/8/2014 [AY 2008-09]	
8)	14A not applicable on investment in shares of foreign companies as dividend from such companies is taxable	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> CIT v. Suzlon Energy Ltd. [2013] 354 ITR 630(Guj.) (HC) Birla Group Holdings Ltd. v. DCIT [2007] 13 SOT 642 (Mum.) (Trib.) ITO v. Strides Acrolab Ltd. [2012] 138 ITD 323 [Mum ITAT] 	As foreign dividend is taxable in India, the investment in shares of foreign companies, shall continue to be excluded from the value of investments as per the amended requirement of Rule 8D(2)(ii)
9)	Disallowance under section 14A is to be added back while computing the book profit under section 115JB	Still Relevant	<p><u>In Favour of assessee:</u></p> <ul style="list-style-type: none"> Reliance Industries Limited v. CIT [ITA no. 4475/Mum/2007, 4537/Mum/2007, 884 & 885/Mum/2009] [dated 13 September 2013] Hon'ble Chennai Tribunal in the case of Lanco Tanjore Power Co Ltd. v. DIT [312 /Mds/2013][dated 21 August, 2013] <p><u>Against Asseessee</u></p> <ul style="list-style-type: none"> CIT v. Goetze (India) Ltd., (2014) 44 taxmann.com 138 (Dei), 	The controversy on disallowance under Rule 8D being considered for Minimum Alternate Tax (MAT) purposes (addition to book profit) has not been dealt with and as such shall continue

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			<ul style="list-style-type: none"> Godrej Consumer Products Ltd. v. ACIT, (2014) 48 taxmann.com 293 (Mum Trib), ITO v. RBK Share Broking Pvt. Ltd., (2013) 37 taxmann.com 128 (Mum Trib) 	

6.0 CONCLUDING REMARKS:

From the above analysis, it is evident that the litigation resulting through disallowance of interest under earlier sub-rule 8D(2)(ii) has been addressed. However, the issues relating to disallowances pertaining to strategic investments, disallowance for the purpose of MAT, disallowance in the absence of exempt income, etc shall continue to remain litigative. The increase in disallowance under the earlier sub-rule 8D(2)(iii) from 0.5% to 1% of the investment will result in increased disallowance, particularly for entities which do not have significant borrowings. Finally, a major recommendation of the Easwar committee to exclude investment in shares for the purpose of disallowance on the basis that companies are already subject to corporate tax and the dividends are subject to Dividend Distribution Tax (DDT), has not been accepted.

7.0 SCOPE & LIMITATIONS:

The purpose of this White Paper ('Paper') is to provide a brief overview of the amended Rule 8D r.w. section 14A of the Income Tax Act 1961. This White Paper is subject to professional advice as this is a new amendment and more clarity can be expected thereon. After review of this Paper, the same should be discussed with us to determine the final course of action. No part of this Paper shall be reproduced without our prior written consent. The Paper is prepared for general use and our views as stated above would be required to be revalidated vis-à-vis the facts of each case. The Government or judicial authorities may or may not subscribe to the views expressed herein. Under no circumstances, the above should be used as any tax avoidance scheme. Further, under no circumstances, our liability in respect of matters discussed in this Paper shall exceed the fees received or the damages actually suffered for this matter, whichever is less.

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